"STRENGTHENING PENSION SECURITY: EXAMINING THE HEALTH AND FUTURE OF DEFINED BENEFIT PENSION PLANS"

HEARING

BEFORE THE

SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS

OF THE

COMMITTEE ON EDUCATION AND THE WORKFORCE

HOUSE OF REPRESENTATIVES

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STRENGTHENING PENSION SECURITY:

EXAMINING THE HEALTH AND FUTURE OF

DEFINED BENEFIT PENSIONS PLANS

Wednesday, June 4, 2003

Subcommittee on Employer-Employee Relations

Committee on Education and the Workforce

U. S. House of Representatives

Washington, D. C.

The Subcommittee met, pursuant to call, at 2:05 p.m., in Room 2175, Rayburn House Office Building, Hon. Sam Johnson, Chairman of the Subcommittee, presiding.

Present: Representatives Johnson, Ballenger, Tiberi, Wilson, Kline, Carter, Anderson, Kildee, Tierney, and Wu.

Staff Present: Stacey Dion, Professional Staff Member; David Connolly, Jr., Professional Staff Member; Ed Gilroy, Director of Workforce Policy; Christine Roth, Workforce Policy Counsel; Kevin Smith, Senior Communications Counselor; Kevin Frank, Professional Staff Member; and, Deborah L. Samantar, Committee Clerk/Intern Coordinator.

Michele Varnhagen, Minority Labor Counsel/Coordinator.

Chairman Johnson. A quorum being present, the Subcommittee on Employer-Employee Relations of the Committee on Education and the Workforce will come to order. I want to thank you all for being here on time and promptly. Thank you.

We are meeting today to hear testimony on strengthening pension security: examining the health and future of the defined benefit plan.

Under Committee Rule 12(b), opening statements are limited to the Chairman and Ranking Minority Member of the Subcommittee; therefore, if other Members have statements, they may be included in the record.

With that, I ask unanimous consent for the hearing record to remain open for 14 days to allow Members' statements and other extraneous material referenced during the hearing to be submitted to the official hearing record.

Without objection, so ordered.

OPENING STATEMENT OF CHAIRMAN SAM JOHNSON, SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS, COMMITTEE ON EDUCATION AND THE WORKFORCE

Good afternoon. And it is that, isn't it? Today we are going to begin a series of hearings on the challenges that face the defined benefit pension system. I will be listening with particular interest to the testimony regarding the pension funding crisis. This hearing will build on our efforts over the last several years to enhance retirement security and expand pension coverage to millions of American workers. After the success in passing H.R. 1000, the Pension Security Act, that mostly deals with defined contribution plans, we now turn our attention to the issues and concerns facing the defined benefit pension system.

Giving workers as many retirement security options as possible should be our goal, and we should encourage employers to offer both 401(k) accounts and defined benefit pension plans to their employees.

While the Committee is interested in the general structure and mechanics of the defined benefit pension plans, we are even more interested in examining the various complex matters that are surrounding it: sponsoring, funding, providing benefits under the system.

In particular, we are concerned with the staggering decline in the number of traditional pension plans over the last several years. We are going to examine the various reasons that plans have been frozen or terminated. I firmly believe that over the years, layer upon layer of red tape and overregulation have strangled these plans and really driven them nearly to extinction. We will also examine the current funding issues facing many employers and plans today.

We should be seeking the correct level of funding for these plans, and we must be sure the money is available to pay for these promised benefits when workers retire. These plans are backed up by the Pension Benefit Guaranty Corporation insurance and American taxpayers. We need to make sure that United States taxpayers aren't left holding the bag for private sector promises.

However, we must be careful not to require over funding, which is an unnecessary drain of corporate resources that may cause employers to consider eliminating the plans altogether.

Besides being crucial to individuals, retirement security pension plans are an important resource for employers in order to maintain their employee talent and dedication. Today we are going to hear from four witnesses with expertise in the pension industry who can tell us about defined benefit plans and the health and future of the system in general.

I am hopeful the witnesses will be able to enlighten this subcommittee on the role defined benefit plans play not only in providing retirement security, but in providing employers with a powerful tool for recruiting and retaining of a valuable and competitive workforce. From the witnesses' testimony today, I think we will all be better able to understand the complexities of our defined benefit pension system and the challenges currently facing us today.

The issues we will talk about today are important because we expect there will be several legislative proposals about pensions in the future. One of the proposals already introduced is H.R. 1776, sponsored by Portman and Cardin. Some of these provisions amend ERISA and are in our committee's jurisdiction, as you are well aware. And I think you are going to see that thing pop its nose up in the next week or two, so we need to be aware and wary.

With that, I welcome you again, and yield to Mr. Andrews, Ranking Member on the Democrat side, for any remarks you care to make.

WRITTEN OPENING STATEMENT OF CHAIRMAN SAM JOHNSON, SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS, COMMITTEE ON EDUCATION AND THE WORKFORCE – SEE APPENDIX A

OPENING STATEMENT OF RANKING MEMBER ROBERT ANDREWS, SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS, COMMITTEE ON EDUCATION AND THE WORKFORCE

Thank you, Mr. Chairman. Thank you for your cooperation today and for your continued fairness and friendship. I thank the witnesses for their excellent preparation. I look forward to hearing from each of you.

I am interested in three broad questions that I hope you will touch on today:

The first is how we can encourage the continued viability of defined benefit plans as a choice for both employers and employees. I agree with Chairman Johnson. We need a robust system in which employees have a choice of more traditional defined benefit plans, defined contribution plans, and the subset of defined contribution plans, employee directed, 401(k)s and others as well. That is a very important menu that I think we have to preserve. There is a real

concern that the defined benefit part of that menu is diminishing. We need to talk about why that is and what we can do about it.

The second thing that I am interested in is the issue of the financial health and under funding of a number of plans, given the roiling of the financial markets over the last number of months and years. One of the major issues for corporate America today is the immense pension liabilities they are going to have to meet and the impact that these liabilities have on the ongoing businesses, and therefore the wages and benefits of today's employees as well as the future health of pensioners.

A corollary to that question is some concerns I have about the treatment of pensioners by companies that have come upon hard times. The steel industry comes to mind as one of them. We need to think through the questions about the fair treatment of those individuals.

The third question, which is related to the first two but in some ways different, is the fact that the GAO study that Congressman Owens and I asked for several years ago indicated that nearly 70 million working Americans have no pension at all. And although the subject of today's hearing is about improving a form of pension that already exists, I don't think you can intelligently have that discussion until you think about the 70 million Americans who have no private pension at all. I view that subset of our working population as a ticking time bomb.

Advances that will be made in life expectancy and health care will hopefully mean that many of those folks will live for a long, long time. I certainly hope that they do. But if the only asset that these individuals have is their Social Security check, if they have their Social Security check, we are, I think, on the brink of seeing a tidal wave of senior citizens living below the poverty line for 25, 30, 35 years. The demands that will place on our budget and on our economy are significant. Obviously there is the important issue of the loss of dignity and the loss of personal standing for those individuals as well.

So I am interested in hearing those three broad questions addressed. I hope that the Committee will be addressing them in legislative form in the weeks and months ahead, and I look forward to hearing from the witnesses.

Chairman Johnson. Well, thank you. We plan on having more than one hearing before we try to do any legislation. As you know, we have a number of new Members on both sides who aren't here, but need to be informed.

I would like to introduce the witnesses at this time. Dr. VanDerhei is a faculty member at Temple University’s Department of Risk, Insurance, and Healthcare Management, School of Business and Management. He previously served on the faculty of the Wharton School at the University of Pennsylvania, and was Director of the Pension Research Council. Dr. VanDerhei's government experience includes consulting work for the Pension Benefit Guaranty Corporation, and the Department of Labor. He is currently the editor of Benefits Quarterly, and a member of the National Academy of Social Insurance. Dr. VanDerhei holds bachelor and MBA degrees from the University of Wisconsin, Madison, and master and doctoral degrees from Wharton School at the University of Pennsylvania. Thank you for being here.

Dr. John Leary is a partner in the law firm of O'Donoghue and O'Donoghue, focusing on collectively bargained employee benefit plans, and, in particular, on multi-employer defined benefit pension plans. He also serves as an adjunct professor at the Columbus School of Law at the Catholic University of America, and he previously served as a staff attorney for the National Labor Relations Board. Dr. Leary received his law degree from Columbus School of Law, Catholic University of America, and his doctoral degree from the University of Maryland.

Ron Gebhardtsbauer is a Senior Pension Fellow for the American Academy of Actuaries, was formerly chief actuary for the Pension Benefit Guaranty Corporation, the chief pension actuary in the creation of the Federal Employee Retirement System at the U.S. Office of Personnel Management, and the head of the New York City retirement practice of William M. Mercer, Inc. Mr. Gebhardtsbauer holds a bachelor's degree from Pennsylvania State University and a master's degree from Northwestern University.

J. Mark Iwry is a Nonresident Senior Fellow at the Brookings Institution economic studies program. Mr. Iwry served as Benefits Tax Counsel of the U. S. Department of Treasury from 1995 to 2001. Prior to joining Treasury, he served as a partner in the law firm of Covington & Burling, specializing in pensions and other employee benefits, as an adjunct professor at George Washington University National Law Center, and as a member of the White House Task Force on Health Care Reform. Mr. Iwry holds bachelor, master and law degrees from Harvard University.

Before the witnesses begin their testimony, I would like to remind Members we will be asking questions after the entire panel has testified. In addition, Committee Rule 2 imposes a 5-minute limit on all questions. We have lights down there that come on when you start, and I think all of you are familiar with them. Finally, we would ask you to please hold your comments to 5 minutes so we have time to ask some questions.

And with that, I would thank the witnesses and Members for their valuable time, and ask Dr. VanDerhei if you are ready to testify, go ahead.

STATEMENT OF JACK L. VANDERHEI, Ph.D., FACULTY MEMBER, FOX SCHOOL OF BUSINESS AND MANAGEMENT, TEMPLE UNIVERSITY, PHILADELPHIA, PA, AND RESEARCH DIRECTOR, EMPLOYEE BENEFIT RESEARCH INSTITUTE (EBRI) FELLOWS' PROGRAM, WASHINGTON, D.C.; TESTIFYING ON BEHALF OF EBRI

Thank you. Mr. Chairman and Members of the Subcommittee, I am Jack VanDerhei of Temple University, and Research Director of the EBRI Fellows' Program.

The Employee Benefit Research Institute is a nonpartisan, nonprofit research institute that focuses on health and retirement issues. EBRI does not take policy positions and does not lobby. Also I wish to emphasize that the views expressed in this statement are mine alone and should not be attributed to Temple University, the Employee Benefit Research Institute, or their officers,

trustees, sponsors or other staff.

In my written testimony I provide an overview of the defined benefit pension plan system and examine the various complex issues concerning sponsoring, funding, and providing benefits to participants and beneficiaries under the system. I discuss some of the pension accounting concerns; attempt to put the current funding crisis in some perspective. I also review some of the relative advantages and limitations of cash balance plans.

I was also asked to comment on the importance of preserving single-employer defined benefit plans and would like to focus the time available for oral comments on this topic. My written testimony discusses the various aspects of retirement income risks and how defined benefits plans treat each one.

Although defined benefit plans are not necessarily more or less generous than their defined contribution plan counterparts with respect to the amount of wealth generated by retirement age for an individual employee, there are fundamental differences in the payout stage, at least for those defined benefit plans that do not offer lump-sum distributions to their employees at retirement.

When defined benefit payouts are offered in the form of an annuity to all retirees, two of the risks mentioned in my testimony are retained by the employer instead of being transferred to the employee, and those are investment risk and longevity risk. The value of the investment risk transfer is well known, as is the fact that defined benefit plans, at least when you are not taking them in the form of lump-sum distributions, eliminate the risk of outliving your income. However, there does not appear to be any quantitative assessment of just how important this latter factor might be.

In my written testimony I describe how the value of a longevity risk transfer is simulated for residents of the State of Massachusetts born between 1936 and 1965. This is essentially the same model I used to simulate the impact of company stock and 401(k) plans when I testified before this Subcommittee last year during the Enron hearings.

However, instead of looking at the impact of asset allocation choices in portfolio diversification, today I am using the model to simulate the amount of time an individual will be alive in retirement, how much they will need to spend each year, and whether they will have sufficient retirement income and wealth to make those payments.

Retiree expenditures in the model are assumed to be both deterministic, which basically means the amount that you spend on things like food, housing, and utilities each year is assumed to be known and a function of the retiree's income, family status, and location.

But there are also still caustic elements. For example, in most years a retiree will not need to spend money on nursing home care. However, for years where I have simulated to be utilized, the amount spent on this service could be catastrophic in value for a retiree.

In the baseline case, it is assumed that all defined benefit plans are paid in the form of an annuity, while individual accounts, such as defined contribution money like 401(k) plans and IRAs

are spent as needed to pay the simulated expenses.

In the alternative case, it is assumed that all individual account money is paid out in the traditional manner of a defined benefit plan. In both cases, deficits are recorded in any year there is not sufficient retirement income to meet bad years' simulated expenses and there is not a sufficient amount in the individual account balances of retiree savings to cover the difference.

Now, before I present the results of my findings, let me just make one brief mention of how I handled what is sometimes a retiree's most important asset, the value of his or her house, less any remaining mortgage.

The value of net housing equity, if any, can make a significant difference in retiree's ability to meet expenses later in life. However, there appears to be no consensus of opinion on when, if ever, retirees are going to liquidate the equity in their house or in what form.

Therefore, the model produces three different scenarios with respect to housing equity. In the first one, the retirees are assumed to never liquidate their housing equity. Secondly, retirees are assumed to annuitize housing mortgage immediately upon retirement. For example, they will go out and purchase a reverse annuity mortgage. And thirdly, retirees are assumed to liquidate the housing equity only when needed to pay expenses and keep the proceeds as a lump-sum.

Well, whether longevity risk transfer inherent in a standard type of benefit plan design will have value to an individual employee will obviously depend, among other things, on their actual life span. As this is not going to be known in advance, the analysis measures the lifetime deficit reduction, simulated to occur when all retirement plan wealth is assumed to be paid out under defined plan-type annuity, and pools results across all members of each birth cohort.

Figures 8a and 8b, which are the last two pages of my written testimony, show you the value of longevity transfers for single males and single females respectively. As you will see, in all cases the defined benefit plan design results in a positive reduction; in other words, retirees are running out of money less often and with less catastrophic results. In percentage terms, the results vary from a low of 8 percent to a high of 26 percent for single males, and from a low of 4 percent to a high of 14 percent for single females.

Mr. Chairman, I know this is a complex topic and there are many factors that affect the future viability of the single-employer pension system. But I would suggest one of the key values in the defined benefit system is that it transfers the risk of outliving your assets from the individual to an employer that can pool this longevity risk across a large number of employees. That factor should not be ignored in the public policy debate over retirement income security.

Thank you very much, and I look forward to answering your questions later.

STATEMENT OF JACK L. VANDERHEI, Ph.D., FACULTY MEMBER, FOX SCHOOL OF BUSINESS AND MANAGEMENT, TEMPLE UNIVERSITY, PHILADELPHIA, PA, AND RESEARCH DIRECTOR, EMPLOYEE BENEFIT RESEARCH INSTITUTE (EBRI) FELLOWS' PROGRAM, WASHINGTON, D.C.; TESTIFYING ON BEHALF OF EBRI – SEE APPENDIX B

Chairman Johnson. Thank you, sir.

Mr. Leary, you may begin.

STATEMENT OF JOHN LEARY, ESQ., PARTNER O'DONOGHUE AND O'DONOGHUE, WASHINGTON, D.C.

Thank you, Chairman, Ranking Member Andrews, and Members of the Committee. I want to highlight a few of the points that I addressed in more detail in my written submission dealing with multi-employer defined benefit plans.

These are plans which are entered into as a result of a collective bargaining agreement between a labor organization and a group of employers. Could be a large group, could be a relatively small group, could be nationwide. That agreement requires contributions to be made by the contributing employers into the defined benefit pension plan; contribution is then pooled, invested, and paid out within terms of a formula set out in the plan of benefits. The amount of contributions going into these plans is fixed by the collective bargaining agreement, which is an agreement which may last as many as 5 years, commonly 3 years. In other words, the income stream into these plans is fixed.

Historically, these plans have been stable. They have, in somewhat of a contrast to single-employer plans, expanded in terms of the number of participants that they cover. They have had a very good history in terms of not having to be salvaged by the PBGC. Only 31 multi-employer plans throughout the history of the PBGC have had to be salvaged, and the assets of the PBGC multi-employer program have remained positive for approximately a quarter century, currently about $158 million.

You can see that these plans historically have been, at least up to now, healthy plans. However, there is a serious threat confronting these plans, and that is their ability to meet their minimum funding obligation. This is an obligation which requires multi-employer defined benefit plans to have sufficient assets to be able to pay benefits when they become due in the future. It has been a hallmark of ERISA, probably been the single biggest reason why ERISA was enacted. And multi-employer plans up to now have not had a problem doing that.

One part of this complex mechanism for funding these plans, in calculating whether they meet their minimum funding obligation, has been to estimate the rate of future revenues in terms of investment return, and also to deal with how to amortize over time the investment experience that the plans have already had.

If there is, and this I believe is a very important point, a failure by a multi-employer plan to meet its minimum funding obligation, liability for that runs to all of the participating employers. They will each have to pay their proportionate share of the shortfall. In addition, each employer, under the Internal Revenue Code, will be liable for paying a penalty of 5 percent of the amount of their extra contributions. That can rise to 100 percent if the deficiency is not cured within the correction period.

Keep in mind that this penalty arises even though all of the multi-employers who have contributed to the multi-employer plan have met all of their contractual obligations, they have paid in all of the money that they have been obligated to under the collective bargaining agreement. Simply put, with this as a possibility, the solvency and the survival of these plans is somewhat jeopardized.

Ordinarily and historically this has not been a problem, but starting in 1999, as you are undoubtedly well aware, with the dramatic decline in the equities markets, these plans have experienced an unprecedented amount of loss. Literally in the lifetime of any multi-employer plan, it has never had three consecutive negative years of investment return, but that is exactly what has happened since mid-1999.

As a result, as they look down the road, which they are required to do by ERISA and by the Internal Revenue Code, these plans see that a minimum funding shortfall could occur and these sanctions, these liabilities could arise. So how are plans going to deal with this, and how are the actors in these plans going to deal with this?

Under the law as it is currently set up, I think it is safe to anticipate that there are going to be a lot of behaviors that will cause harm to multi-employer plans. Most commonly I think what we can envision happening, is that employers to multi-employer plans, as they look down the road and they see that perhaps in 4 years I could have significant liability for making up this minimum funding shortfall, those employers could very reasonably and very understandably decide, "I don't want to participate in this plan any further. As soon as my collective bargaining agreement expires, I am out of here. I am going to withdraw from the plan or not renew a bargaining agreement requiring contributions to the plan."

Trustees, as they look at this problem, are equally committed to trying to avoid it. I certainly see it as imaginable although imprudent for trustees to look to investment strategies which might bring in more money but also would certainly bring in more risk.

Once those types of behaviors happen, and particularly once an employer starts to leave, you are going to have a number of negative consequences: First of all, of course, the income stream lessens. Fewer employers are contributing to the plan. Second, an increased liability gets to be imposed upon the remaining employers. Third, the possible new employers that all of these plans need to survive are not going to be attracted to this plan. It is simply going to be a rational decision by an employer not to enter into a plan if I have possible, significant liability for benefits.

As a result, these plans are going to experience a significant funding shortfall. Section 708 provides some relief for that provision by allowing the amortization of investment losses to be

extended from 15 to 30 years. It would eliminate, in my view, a number of these negative consequences.

Thank you very much.

STATEMENT OF JOHN LEARY, ESQ., PARTNER O'DONOGHUE AND O'DONOGHUE, WASHINGTON, D.C. – SEE APPENDIX C

Chairman Johnson. Thank you. I appreciate you shortening it up there at the end. Lawyers like to talk. I understand. That is okay.

Mr. Gebhardtsbauer, you may proceed now. Thank you.

STATEMENT OF RON GEBHARDTSBAUER, SENIOR PENSION FELLOW, AMERICAN ACADEMY OF ACTUARIES, WASHINGTON, D.C.

Thank you, Mr. Chairman, Ranking Member Andrews, and distinguished Members of the Committee. Thank you for inviting us to testify today on defined benefit plans. My name is Ron Gebhardtsbauer, and I work for the American Academy of Actuaries. We are the nonpartisan professional organization for all actuaries of all practices in the United States.

DB plans are an essential element of retirement security along with DC plans. While younger employees understand and value the cash nature of DC plans, older employees and retirees will tell you that cash does not bring retirement security; a stable DB pension for life does. Thus there are advantages to having both types of plans. So many large employers have both, a DB plan and a 401(k).

Workers appreciate their 401(k) plan when the stock markets are doing well, but when stock markets go down they prefer their DB plans. And employers provide retirement plans not only for altruistic reasons, but also to help them maintain their workforces and because they have tax advantages. And the nation benefits by having a huge source of efficiently invested assets in our economy.

In my written testimony I provide many of the advantages of DB plans, so I will just give a few here. For employees, DB plans are more likely to provide a stable income for life. Employees wouldn't have to worry about a bear market when they retire or right after they retire. And they won't have to worry about running out of money. For employers, DB plans provide design and contribution flexibility, although employers would like to have more flexibility in the contribution area, in good years to contribute more, and less in difficult years. And for the Nation, DB plans help reduce poverty rates better at old ages.

With all of these advantages, you would think that DB plans would predominate. Unfortunately, that was only true in the past. There has been a dramatic trend away from DB plans towards 401(k)s. In the 1970s, as you will see from the chart over to my right, 40 percent of the private sector workforce was covered by a DB plan. That is the blue line going down.Now it only covers about half that, or 20 percent. And DC plans now predominate, the purple line going up. Those are primarily 401(k) plans. So the remaining DC plans are only at 12 percent. They are falling further.

Why did this happen if DB plans can mimic a DC plan? A major reason is that DC plans can have features that DB plans cannot have. So how can Congress help DB plans to be more competitive? One way would be to allow DB plans to have some of those features that 401(k) plans can have. And that way employers would then be able to choose what is best for them and their employees. For instance, Congress could allow a DB plan to have pretax employee contributions. Right now they can't. Same thing. They could allow DB plans to have employer matching contributions, just like the 401(k), but DB plans can’t.

In my written testimony, I suggest applying other 401(k) rules to DB plans, such as allowing phased retirement to create a more level playing field. People are calling this idea the “DB(k)” idea.

Another reason that choice is biased is that the rules for DB plans are much more complex and costly for DB plans. For example, in the 1970s, the administrative costs for a DB plan were less than for a DC plan. But now they are 50 percent more for the DB plan, and according to a Hay Group study, it was because of laws and regulations. In addition, finally, DB laws and regulations have not kept up with new plan designs and with the changing economy.

For example, unusually low Treasury rates have made pension contributions much larger than intended. And a congressional fix expires this year. Decisions are being made daily to freeze and terminate pension plans for cost reasons right now. So a permanent fix is needed soon and immediately. It is unfortunate though that we haven't solved this already, since the major players are so close.

A proposal under consideration in the Senate last month suggested using 100 percent of a conservative corporate bond index. An administration official testified in April that they also liked the corporate bond rate, but they were considering using a yield curve instead of just one average rate for all plans.

However, a curve adds much complexity, without really changing the numbers much, when other best practices are used. Therefore, you might want to convene a summit on this issue with interested parties to iron out some of these small differences between the parties. It is important that Congress act soon on these issues, particularly the Treasury rate fix, as employers need to know now what next year's contribution is going to be. In addition, we need to fix the other rules soon so that employers don't give up on their DB plans.

The earliest baby boomers have already started to reach retirement age. Let's create rules and laws so that they can have a more secure retirement. Thank you for this opportunity to speak

before you. I will be ready for questions when you have them.

STATEMENT OF RON GEBHARDTSBAUER, SENIOR PENSION FELLOW, AMERICAN ACADEMY OF ACTUARIES, WASHINGTON, D.C. – SEE APPENDIX D

Chairman Johnson. Thank you, sir.

Mr. Iwry, you may proceed.

STATEMENT OF J. MARK IWRY, ESQ., NONRESIDENT SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

Thank you, Mr. Chairman, Ranking Member Andrews, distinguished Members of the Committee. I would like you to bear in mind, if you would, two basic points as you consider the issues before you today.

The first is that the tax-qualified pension system needs to do more to give the taxpayers their money's worth. Treasury estimates that we spend about $192 billion in foregone taxes in order to subsidize pensions. Of that, 92 billion relates to 401(k)s and IRAs, and the other 100 billion to employer-funded plans, both defined benefit and defined contribution. This means that the taxpayers obviously have a major stake in the private pension system, much like a private investor in a business transaction who has made a substantial equity investment and expects a reasonable return on that investment.

For the taxpayers the interest in ensuring that their money is used efficiently and for its intended purpose, in other words a good return on their investment, is to provide retirement security to those who need it the most. Unfortunately, moderate and lower-income households are disproportionately represented among the roughly 70 million people that you referred to, Mr. Andrews, as being excluded from the private pension system.

It has been estimated that about 80 percent of people with earnings over $50,000 a year are covered by an employer plan, while fewer than 40 percent of people with earnings of $25,000 or under are covered. And when they are covered, the moderate and lower-income people are likely to have disproportionately small benefits. When they are eligible to contribute to a 401(k), they are more likely not to contribute. And very few contribute to IRAs. So the distribution of benefits in our system, both the retirement benefits and the associated tax benefits, is tilted upward.

Providing security for the moderate and lower income workers should be the first policy priority of our system, not only because public tax dollars need to be devoted to enhancing security in retirement as opposed to affluence in retirement, but also because this is efficient. Tax expenditures that are of use mainly to higher income people tend to generate shifting of other savings from non tax-favored over to tax-favored uses; whereas tax incentives that are targeted to

lower and moderate-income workers tend to increase net savings because these people have less savings, if any, to begin with.

Let me recall for the Subcommittee one key reason why the system isn't doing more to cover moderate and lower-income people. The juice in our system, the tax preferences, is structured in such a way that they have to do with one's marginal tax rate. If, like three-quarters of the working population, your tax bracket is 15 percent, 10 percent, or zero, you pay payroll tax but you don't owe any income tax.

The tax-favored treatment of pension contributions, whether it is DB, DC, 401(k) or IRAs, is worth very little to you. By contrast, if you are in a high marginal tax rate, it is worth quite a lot.

My second point is DB plans are valuable and important, but the preservation of defined benefit plans is not the most important thing at stake. The DB/DC distinction should not be the main focus, because the larger issue is whether as a nation we are stepping away from the employer-based pension system as a whole, DBs and DCs alike, in favor of a do-it-yourself approach that is based on individual accounts.

An employer system can be a powerful way of achieving broad coverage, as illustrated by the many large defined benefit plans that cover millions of individuals and provide meaningful benefits to them. The system tends to have cross-subsidies that use the interest of higher-income, higher-bracket taxpayers to encourage their more reluctant coworkers who are in lower tax brackets to go ahead and save.

Employer contributions tend to work because they provide automatic coverage, actual benefits, as opposed to just the opportunity to save and get benefits. So the more pertinent distinction is between pensions and individual savings. By pensions, I mean employer-sponsored plans or multiple employer or other collective arrangements that actually deliver retirement benefits, be they defined benefit, profit sharing, money purchase pension, stock bonus, including employer contributions to 401(k)s and benefits that are targeted to retirement income as opposed to only an account balance that people can consume early on in their careers.

DB plans have been losing out, as my colleagues have said, not to DCs in general, but to 401(k)s. And 401(k)s can leave people behind. 401(k)s play an important and constructive role in our system. And certainly those that retain the incentive structure that makes the employer want to encourage the average workers to save in order to provide more savings opportunities for the higher income pursuant to the nondiscrimination test in the 401(k); those play a particularly constructive role. But a fairer and more effective distribution of benefits to increase both retirement security and national savings calls for us to encourage employer contributions first and foremost.

Thank you, Mr. Chairman. I am happy to enter into discussion and take questions.

STATEMENT OF J. MARK IWRY, ESQ., NONRESIDENT SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, D.C. – SEE APPENDIX E

Chairman Johnson. Thank you, sir. We appreciate your testimony as well.

Mr. Leary, I might ask you, don't multi-employer plans have a different funding rule from a single-employer plan, and are there any single-employer funding rules that allow those plans to average loss over 15 years or 30 years even? And I believe section 708 of the Portman-Cardin bill would allow multi-employer plans a one-time advantage to average loss over 30 years. Why should multi-employer plans be given such a big advantage over single-employer plans?

Mr. Leary. Thank you, Mr. Chairman. Originally, my recollection is that there was a 15-year amortization period for experienced gains and losses in ERISA for both single-employer plans and multi-employer plans. That was changed primarily because of the PBGC's strong feeling that the single-employer plans needed to be distinguished, and a shorter period was appropriate for single-employer plans which tend to be, on the whole, less stable than multi-employer plans. So that responds to the first part of your question.

In regards to why should multi-employer plans get a more favorable, longer amortization period than single-employer plans, a single-employer plan always has the opportunity, if it meets a potential funding shortfall, for the employer in his capacity as plan sponsor to contribute additional amounts into the plan. The only restriction that the employer would run into would be he could not contribute so much that he would hit the maximum funding limitation ceiling and lose the ability to take a tax deduction on these contributions, but the employer is, in a way, in control of the purse strings as the plan sponsor.

In a multi-employer plan, the trustees, the sponsors of the plan, do not control the purse strings; the purse strings are really controlled by the bargaining parties, and the trustees deal with the money that comes from the bargaining parties in these bargaining agreements.

Chairman Johnson. You are talking about union plans.

Mr. Leary. Yes.

Chairman Johnson. Which are only, in my view, about 70 percent funded. Is that true?

Mr. Leary. I believe that the figure is in fact higher. I believe that they are better funded than that. I don't have the precise number.

A problem which the multi-employer plans confront is if they run into a shortfall, they do not have the ability to put additional money in because the amount of the money coming in is already fixed by the bargaining agreement. And it is very unlikely that an employer or a group of employers would be willing, say, in midterm of a 5-year bargaining agreement, to agree to make additional contributions. So that lack of mobility that multi-employer plans have is a primary

reason.

Chairman Johnson. Yes, but when they make the agreement, the union agrees to put in “X” amount of dollars and hold the plan at a certain level, and they don't do that. Is that true or false?

Mr. Leary. Well, first of all, Mr. Chairman, the union does not agree to make any contributions. With the “multis”, all of the money comes from the employers. So they are the sole contribution source.

Chairman Johnson. But do they put it all in that pension plan, as agreed?

Mr. Leary. Yes. All of the money goes into the plan. And then the administration of it is handled by a group of trustees, equally derived from the union side and the management side.

Chairman Johnson. So what happens when you get a shortfall? Because, you know, under our Federal rules, we require companies to maintain plans up to a certain level. And you admitted that even though the 30-year bond rate went away and hurt us, we are still using a rate to keep the pension plans fully funded. Companies have to do that. Why don't unions?

Mr. Leary. The 30-year bond rate is not in effect for multi-employer plans and it never has been, Mr. Chairman.

Chairman Johnson. Okay. Thank you for that information.

By the way, Portman, Cardin, and I wrote a letter to the Treasury Department two years ago and asked them when they were going to determine a rate. They still haven't answered us. So what I think you may see is that the Congress may decide to do something on its own. I hope we can solve that problem. And also you know as well as I do, it is hard to find a defined rate that everybody is agreeable to.

Thank you. My time is up.

Mr. Andrews.

Mr. Andrews. Thank you. I thank all of the witnesses for excellent presentations. I want to start with Mr. Leary.

You acknowledged the fact that we have had this 3-consecutive-year downturn problem. And you have embraced a solution of a one-time option to go to a 30-year amortization of that loss rather than 15-year. Is that correct?

Mr. Leary. That is correct.

Mr. Andrews. What happens if we have another 3-year downturn?

Mr. Leary. The first point to make about that is that the 3-year downturn, which hopefully we are coming out of based on first quarter returns which have been better, had been unprecedented. We haven't had one for 60 years. So history gives us a certain degree of hope but obviously not a guarantee.

Probably the most important thing that is going to come out of this extension of the 15-year amortization period to 30 years is it gives these multi-employer plans more time to address this problem. And I think you are going to see multi-employer plans respond to this, and even if this relief is granted, you are still going to see plans, I think, reduce benefits.

Mr. Andrews. My concern is that any way you look at this, the extension of the amortization period is a way to borrow against future earnings to cover the 3-year shortfall. And you know what, if it is a 3-year shortfall that is going to work out fine. But none of us knows whether this downturn is going to be replicated in the near future. I am concerned about the fact that we might simply be postponing a far deeper crisis by permitting that to happen. I don't know whether it will or not, nor do you.

But I do worry about a much greater shock to the system if we had, you know, seven bad years out of nine, and we are borrowing in the future that way. How do you respond to that?

Mr. Leary. If this relief comes I think that multi-employer plans are still going to have serious underlying problems. What the relief gives is time, not money. What these plans need is money. I think you are going to see multi-employer plans look at the design of their plans, look at possible reduction in benefits, look at reductions in the rate of future accruals, look at possible increases in contribution streams, and look at the possibility of bringing in new employers. I think they are going to be doing all of these things. I think they are going to be able to do them better, particularly if you think about that in terms of cutting of benefits.

Mr. Andrews. And in terms of a less urgent environment.

Mr. Iwry, a two-part question for you. What do you think the most effective way would be for us to use the tax incentive that you talked about to gain more coverage for the 70 million or so who have no pension, number one?

And, number two, what suggestions do you have for us outside of the use of the existing tax incentive that might expand coverage? I know that you were centrally involved in the saver's credit that was enacted in 2000. And I appreciate your involvement in that. What ideas do you have for us there?

Mr. Iwry. Well, first, Mr. Andrews, I think that that saver's credit needs to be expanded. It was proposed in a much more robust form. And I think you have advocated that it be expanded in proposed legislation that you have submitted and I hope you will resubmit this year.

The saver's credit is basically intended to be a “win-win”, as you know. It corrects the imbalance in the tax brackets that applies to retirement savings incentives by giving people who are in the zero percent bracket or in the 10 or 15 percent bracket a tax credit so that they get more

proportional benefit from savings.

Mr. Andrews. Sort of like an employer match, subsidized by the Federal Government?

Mr. Iwry. Exactly, just like all of the tax benefits are in a sense like an employer match.

Mr. Andrews. That is because many of the folks who would be in this bracket don't work for an employer that can afford an employer match, typically. They are in low-margin industries, or thin-margin industries.

Mr. Iwry. Exactly, so this encourages new plans, because it provides a match that a small business might not otherwise be able to provide on its own. That helps when it sees that the government is willing to step in and provide the match. Without this in a sense, to follow your analogy, the tax deductions and the tax exclusions that everybody gets on their retirement savings are like a government-provided employer match that are at a much higher rate.

Mr. Andrews. How can we make better use of that $192 billion to stretch coverage further then?

Mr. Iwry. Well, for one thing, I think we need to take this saver's credit idea and build on it. That is, provide for more tax credit rather than deduction-based incentives so that the system is more equitable and actually encourages more saving, because there are more moderate- and low-income people that are involved, and we penetrate that 70-million-person half of the population of the workforce that is not now covered.

We can also do more to encourage employer or automatic contributions. There have been proposals for a tax credit which I had been involved in when I was at Treasury for employer matching contributions and non-matching contributions that represent high-quality coverage. In other words, that are targeted to people who are not highly paid, that are quickly invested, that involve covering everyone in the workforce except very high turnover folks, that are not leaky, but don't let the money be used for other purposes early in people's careers. That is the kind of contribution that we want to try to encourage in our system.

And I think if we look behind the labels, defined benefit, and defined contribution, to the actual specific attributes of what it is that we are encouraging with our tax favored treatment, we will be a lot more effective.

Mr. Andrews. I see that my time is up.

Mr. Chairman, I make two requests. One is would Mr. Iwry expand his remarks for the record in writing.

And to all of the witnesses, I would ask you to submit in writing, if you would, your thoughts about a proposal that Chairman Boehner and I have talked about at the Full Committee level, which is taking employers that have robust defined benefit plans presently, and giving them some regulatory relief or safe harbor-type treatment from some of the new requirements on defined

contribution plans where they have both.

This is the employer who has both a DC (defined contribution) and a DB (defined benefit), and almost as a reward for having a robust DB plan, the DC would be regulated in a slightly less onerous or difficult way. I would be interested in the thoughts of the panel on that.

Chairman Johnson. Thank you. We would appreciate your comments on that. I hope you all don't mind forwarding that to us.

Mr. Ballenger, you are recognized for five minutes.

Mr. Ballenger. Thank you, Mr. Chairman. As a fellow who has had a defined benefit plan that I changed to a defined contribution plan, that I changed to a 401(k), that I changed to an ESOP, and the IRA was in there at one time or another, it seems like every time I was getting something settled, the government would come in and screw it up.

So one thing I would like to ask Mr. Gebhardtsbauer have the defined benefit plan costs tripled because of ERISA? Why have those costs of operation tripled?

Mr. Gebhardtsbauer. There are lots of reasons. If I got out my original ERISA, it is that big. And now I get out my law and regulations, and it is this big. That is just the laws and regulations. We have court cases.

Mr. Ballenger. That is the reason I don't have that those plans any more.

Mr. Gebhardtsbauer. In addition, we have additional laws now that we didn't have back then. And sometimes they conflict. Sometimes you have things like age discrimination rules, and they conflict with rules that say you can't favor the highly paid. It is more likely that the older employees are also the more highly paid, and the ones with more service.

So it is very difficult sometimes to figure out how you can make sure you comply with all of these rules. Some of the concern that I am talking about now is that you have rules on the DB side, and you don't have them on the DC side. Or you have things that you can do on the DC side that you can't do on the DB side.

So a lot of these rules have good reasons for them. And you want to maybe keep the intent of some of these rules, but maybe there are ways to simplify them. As I mentioned in my testimony, too, some of the rules haven't kept up to date. It is easier to keep the defined contribution rules up to date, because I think we understand the defined contribution rules a lot better.

But the defined benefit area is much more complex. So it is hard to figure out how to keep them up to date and reflect the new economy, lower interest rates, or the new kinds of pension plans. For instance, the cash balance plan is an employer attempt at creating a plan that is similar to the DC or 401(k) plan. And some of the ideas that Mark Iwry just brought up only apply to the DC side. So, for instance, the credit that encourages the low-income people to put their 401(k)

contribution in, you could also do that in the cash balance area to encourage employees, if it was allowed, to contribute to the cash balance plan too. But, right now the rule is only on the DC side.

Mr. Ballenger. Right, I understand.

I think it was Dr. VanDerhei who mentioned homeowners. Do you have any data as to the percentage of retirees who own their own homes, and what the average equity would be? Is there any kind of study that has got information like that?

Dr. VanDerhei. Yes, sir. Actually we have done studies now for two states; specifically, Massachusetts and Kansas. And the one thing I can tell you is that any general number I would give you would be meaningless, because there is so much geographical variation. I would be more than happy to forward the information that we have collected on it by geographical area.

We have it both as far as percentage that has housing equity and what its value is. We also have the distribution. And probably, most importantly, we have it by family status and gender. And it is the single females in the both the states of Kansas and Massachusetts that we ran the simulations for that are definitely the target group most at risk, primarily because they have very little housing equity in addition to some of the other things we have talked about today.

Mr. Ballenger. I realize that I am in a strange situation, but do any of you have an explanation for the stupid rule that states when you get to be 72 the government tells you how long you are going to live, and your 401(k) and your IRA and your ESOP all have to be liquidated according to their schedule?

Can someone tell me the reason for that?

Mr. Gebhardtsbauer. I think it is to ensure that the pension money is used for retirement.

Mr. Ballenger. They tell you to take it all.

Mr. Gebhardtsbauer. Right. People are living a lot longer than they did when that rule was created. So some suggestions are to raise that age up to a higher age. And a lot of actuarial studies have been performed on when is the right time to buy an annuity. They now say, back when the average life expectancy was 65, such as when we were creating Social Security, it made sense to buy an annuity then.

But today, they say it is more efficient to buy annuities at later ages. Sometimes those rules that say that you have to start taking distributions out of your plan force people to start taking it before it would make sense, for instance, to buy an annuity. But then, of course, if we defer that to age 70 to 75, that means for a while there will be a temporary period where there will be less revenues coming into the government. So it is difficult to make that change.

Mr. Iwry. Mr. Ballenger, may I add that the purpose of the rule, as Mr. Gebhardtsbauer said, is to try to ensure that the tax-favored treatment that was given to these contributions during your whole career really goes to its intended purpose of retirement security rather than estate planning. Not

that there is anything wrong with estate planning, but the purpose of that tax break was retirement security, not passing it on to one's heirs.

The rule, therefore, doesn't actually require people to spend, as you know, the money; it is just that you have to shift it out of your IRA or qualified plan account into your taxable account. It can be with the same financial provider. It is just that the government wants to see that you are using that part of your assets for retirement security.

Mr. Ballenger. Some of us are still working past that age. You just put that money right on the top of salary and it throws you into the next tax bracket.

Mr. Iwry. We changed the law a few years ago to make sure that if you are still working for an employer, past that age, you can postpone that payout. You can wait until you actually retire before you have to pay it out. When I was at Treasury, we also liberalized that rule in response to the kind of concern that you are expressing; that is, because people are paying much more in health care costs later in life, long-term care costs and so on. We liberalized the rule, and we simplified it so that you don't have to take out as much. Again it is not taking it out; it is just moving it into taxable accounts. Congress is now proposing to do more, and that could be done.

But another way to structure that is just to exempt people with small accounts from that rule. Anybody under $50,000, which is a majority of the population, wouldn't have to comply. They are not the estate planners in the first place.

Mr. Ballenger. Thank you, Mr. Chairman.

Chairman Johnson. Thank you.

Mr. Kildee.

Mr. Kildee. Thank you, Mr. Chairman. My question is going to be rather specific and maybe provincial. The largest employer in my district by far is General Motors. And they have had a retirement plan for their hourly workers at least since 1950. And General Motors, earlier this year, announced that the cost of its unfunded pension will triple to $3 billion in 2003 compared to $1 billion in 2002. You are probably familiar with that, Mr. Iwry.

Can GM address, and also acknowledge that their earnings will fall about 26 percent because of that increased funding? Can GM address this without any governmental intervention or without any changes in our law? Or are there some changes in our law that might be of assistance for corporations like General Motors and specifically for General Motors?

Mr. Iwry. Mr. Kildee, I don't think that GM, or companies in a similar situation, should have to address that without intervention from the government, because I think that the current situation is not tenable and is not fair to employers or employees.

The funding rate, as people have discussed, is based on 30-year Treasury bonds which Treasury has stopped issuing, as you know. We have an anomaly in our system now that we have

got a discount rate that measures the companies' liabilities in a way that is causing those liabilities to increase artificially because the discount rate doesn't work anymore. It doesn't reflect what it is supposed to reflect since the 30-year Treasury has been disappearing, and Treasury has bought back debt during the time when we had surpluses. So that market just isn't working and we need to fix it.

I endorse my colleague's recommendation that this be fixed promptly. You referred to a summit. I think that is a great idea, something like that involving this Committee and the other committees of jurisdiction. I would suggest that this be done this month, if at all practical and convenient for the Members, because companies need relief promptly. And the technical issues between the Treasury's preferences as to how to solve this and industry's preferences can be worked out, I think, among technical experts under the guidance of the Members and the Executive Branch.

At the same time, if I can just add, that interest rate, as it is adjusted and set to some new benchmark that is higher than the 30-year Treasury, does not need to apply to lump-sum calculations in the same way. That is, when you figure out how much an employee is entitled to get if he or she takes their pension as a single-sum payment, or whether the employer is entitled to cash out someone involuntarily if their lump-sum is very small, that interest rate has been different, has been lower than the funding interest rate for years. And I suggest that it continue to be lower.

Mr. Kildee. I appreciate your answer, and maybe this summit idea or Treasury somehow issuing or maybe responding to our inquiries would be important, because for my district, I mean, both the stability of the pension fund is important as is the profitability of General Motors. They are the ones who provide the jobs in my district, so I am concerned about both things. I talked to Rick Wagner of General Motors and I know he is very concerned about this. And I appreciate your response and will pursue that further.

Thank you very much.

Chairman Johnson. Thank you for your comments. I think we all agree that that is a significant problem that needs to be addressed fairly quickly. And I hope that, as slow as the Congress is, maybe we will get it done this month.

Mr. Kline, you are recognized for five minutes.

Mr. Kline. Thank you, Mr. Chairman, and thank you to all the witnesses for coming today. It is fascinating testimony, and I really enjoyed the questions and answers.

As a military retiree, I suppose I am the beneficiary of a pretty solid, defined benefit plan, and I have some great confidence in the solvency of the employer who is providing those benefits. The discussion here today seems to be hinging on the solvency of these defined benefit plans and how they are computed. And I was struck first I think, Mr. Gebhardtsbauer, you talked about the 30-year Treasury, the Chairman picked it up, Mr. Kildee and so forth. Could you help me understand what the problem is in these plans that are related to Treasury rates? Just sort of get to some basics for me?

Mr. Gebhardtsbauer. Great question. I have a chart over to my right that shows how, when Congress initially put the rule in on Treasury rates, Treasury rates were very high. They were way up in the double digits, much higher than actuaries were assuming for long-term expectations. As you can see, though, all interest rates have fallen a lot, and some of it is due to exactly what Mark Iwry mentioned earlier. That is that we had a surplus in the late 1990s, and eventually at least the CBO projections in the late 1990s said that we were no longer going to have debt. And so interest rates fell, and Treasury rates fell faster than corporate bond rates.

If you look over at that chart, you will notice that it is pretty hard to see, but the maximum interest rate permitted by law in the past actually was very close to the corporate bond rate. And so if you really want to stay with what the original law stated, you would want to keep it back there where the corporate bond rate is. So even though it was based on the Treasury rate, it was initially 110 percent of the Treasury rate, and that got you close to corporate bonds.

But then Treasury rates fell so low that when you applied this formula you got a number and actuaries can no longer use an interest rate even anywhere close to corporate bond rates. In fact, it was less than the interest rates that insurance companies were using to price annuities. In other words, you had to put more money into that pension plan than you really needed. You could have bought an annuity for everybody and still had leftover money, and still the government would say you need to put more money in there.

So some of the reasons now are because people are getting out of the stock market. Even though we don't have government surplus anymore, people are getting out of the stock market and moving to Treasury bonds. And again interest rates kept going lower. So the law is forcing these interest rates to be much lower, which forces contributions to the pension plans to be much higher than necessary. And so this temporary fix got it back up to corporate bonds, but the temporary fix is gone by the end of the year. And in fact, decisions have been made in courts already saying that, for instance, U.S. Airways can't afford its pension plan any longer. And part of that decision was can they afford next year's contribution? And it didn't look like they could.

Mr. Kline. So, you are proposing then that we adopt a corporate bond rate in an official way? That this Committee should be addressing that?

Mr. Gebhardtsbauer. The economy actually doesn't take a position on exactly what it should be. In fact, you will see some of the material on this in our paper and indications to a paper that we have had before.

Mr. Kline. You must admit that it is difficult.

Mr. Gebhardtsbauer. In the chart we have recommended it to be somewhere in the range of between an annuity rate and a corporate bond rate. And this rate that was proposed recently by a Senator in a bill was in that kind of range, and Treasuries in that range, when they talk about using a corporate bond rate.

The reason why the economy doesn't pick a particular solution is because there is a tension there between benefit security and benefit adequacy. And that is not a decision to be made by the

academy, but more appropriately lies with Congress to balance these issues. But a corporate bond would be in that range that we have been talking about.

Mr. Kline. Thank you very much. I really appreciate it.

And I yield back, Mr. Chairman.

Chairman Johnson. Thank you. If it was proposed by a Senator, that must make it bad, "ahem" good. Excuse me. I didn't say that. We are not supposed to comment on the Senate over there, so I will withdraw that statement.

Mr. Tierney, you are recognized. Do you care to question?

Mr. Tierney. Yes, I do. Thank you, Mr. Chairman. Thank you, members of the panel.

There was an article in the Boston Globe today talking about the fact that one third of the lump-sum payments that millions of Americans are eligible to take for their employee pension funds when they retire, change jobs, or are laid off might be reduced because of this legislation that is pending; they might have their amount reduced. You mentioned, Mr. Iwry, a second ago about having a separate interest rate for that? Is that the general consensus of all members of the panel that we ought to decouple the interest rate for the lump-sum determinations as opposed to others? Start right to left.

Mr. Gebhardtsbauer. The economy doesn't take a position, so we wouldn't recommend what should be done. But we do note in our paper that right now, as Mark Iwry mentioned, the interest rate is much lower for determining lump-sums. It is already decoupled. And it is so low right now at Treasury rates, that it is encouraging people to take lump-sums. And that may not be good for them or good government policy.

A lot of people for instance took lump-sums in late 1999. Probably even advisors would say that that lump-sum is more valuable because you can take the lump-sum out and buy an annuity. And the annuity would be bigger from the insurance company than what you would have gotten from the pension plan, because the employer has to subsidize that lump-sum because of government rules. And so you want to make sure it is not as conservative as it is now. It doesn't have to be the exact same number.

Mr. Tierney. But do you see a danger in having it the same exact number in that those people might be treated unfairly?

Mr. Gebhardtsbauer. Where you said it will affect costs, if you move the interest rate up for determining how much a pension plan costs and what are the liabilities but you don't move up the lump-sum, then the pension plan will still cost a lot more than if you would move the lump-sum rate also up. If you don't move it all the way up, then again, the pension plan will cost a little bit more than maybe originally intended.

So they don't have to be the same, but it is a cost issue for the employer.

Mr. Tierney. Cost for the employer or cost the employee big time; right?

Mr. Gebhardtsbauer. I think you mentioned, by the way, that the interest rate would mean that lump-sums are lower. They would be lower than if the current rule applied, but they actually won't go down because there is a transition rule that phased it in slowly. Actually, Treasury rates and corporate bond rates aren't that far apart anymore. And so it phases it in between now and the year 2010. It is such a slow phase-in that, because you accrue an additional year of benefit and you are one year closer to retirement, that the lump-sum actually doesn't go down.

I know Mr. Iwry got calls the last time something like this was done because people actually saw a decrease in their lump-sums. But with the transition rule that is being proposed, the one that you mentioned, no one would actually see their lump-sum go down, it will just go up. It won't go up as fast as it would have.

Mr. Iwry. Picking up on my colleague's last point, I think it is not only fair, but prudent to make sure that the lump-sum rate is not increased unduly. The last time lump-sum rates were increased was in connection with the GATT legislation in the mid-1990s. The interest rate was adjusted for funding and lump-sum purposes, and the thought was to get it more in line with market rates. There was a lot of pain inflicted, and there were transition rules in place. The issue had been foreseen, but the transition rules were not effective enough. And the members heard from constituents in very acute, pointed ways about the problem this had caused their lump-sums.

This time around I suggest, Mr. Tierney, two elements: Number one, the interest rate is distorted because we are using this 30-year Treasury bond that is no longer being issued, but interest rates are, of course, low in general. Even if we were using something like the 30-year Treasury rate as it was a few years ago before these unusual events, before it was discontinued, we would be in a low-interest rate environment and lump-sums would be higher. Arguably, once you correct for the anomaly that this bond is no longer being issued, you have just got a low dip in the normal interest rate market performance, the ups and downs of the market, of the business cycle that are part of the bargain.

I mean, employees could be viewed as getting a windfall because their lump-sums are larger because of generally low interest rates, but they are getting the opposite in their 401(k)s and their IRAs, as people are so acutely aware. I question whether this is the time to tell people that they ought to also take a hit on their defined benefit payments.

In addition, the companies that have been making the argument, which I think is a legitimate argument, that we don't want to encourage leakage in our system, are coming to an intermediate point to the effect that we don't want to encourage lump-sums. Lump-sums don't necessarily equal leakage. Most lump-sum dollars are rolled over, even though the small lump-sums are unfortunately not. But the large ones are. And the companies that are concerned about not encouraging lump-sums, by not letting them be as large as they might otherwise be, are also converting their traditional DBs to lump-sum plans, if you will, cash balance plans whose very

design is to pay lump-sums.

Mr. Tierney. Is it the employers who decide whether or not there is going to be a lump-sum distribution? Do they have control over that? Or is that something that they don't have control over?

Mr. Iwry. Mr. Tierney, the employer has the control over whether to offer that as an option; but unless the amount of the benefit is $5,000 or less, the employer doesn't have control as to whether the employee elects the lump-sum. But as a practical matter, if it provides a cash balance plan, I am in favor of cash balance plans. I am not criticizing them for this reason. But if an employer provides a cash balance plan, it is designed to pay lump-sums, and with very few exceptions nearly all employees take lump-sums.

I think the cash balance issue is one of transition. The plans can be very useful even as they pay lump-sums. They have to offer annuities, so people who want annuities can take them. The problem is simply how best to protect older workers when companies convert from traditional to cash balance plans.

Mr. Tierney. Thank you. And thank you, Mr. Chairman, for the extra question.

Chairman Johnson. Mr. Wilson, you are recognized.

Mr. Wilson. Thank you, Mr. Chairman.

And thank you all for being here today on such a tough topic. I think all of you have been extremely instructive.

Dr. VanDerhei, can you explain to us how the change in the ratio of active workers to retired workers is affecting the defined benefit plans? How long will this trend continue, and how can plans best deal with the issue?

Dr. VanDerhei. Well, that ratio is something that is certainly going to be very plan specific. You have industries now where, for a variety of reasons, international competition one of the most important, the number of people that are currently working per retiree is changing relatively drastically. You have situations in many cases where the pre-funding has already been established, realizing that those individuals who are now retirees when they were working and in much larger numbers, that the pre-funding of the current defined benefit system was designed primarily to handle that.

So this is not a pay as you go system as sometimes people think Social Security is, but something closely aligned to that, but not completely. And it is not necessarily going to be the type of situation where if the ratio that you mentioned starts to change drastically, that that definitely will have an implication on the funding, because of the pre-funding rules that have already been set in place.

Having said that, however, there is no doubt that when those ratios change to the point where the number of actives available, as far as the number of retirees that are currently being paid from the planned finances, certainly does make the volatility much more of an issue for the defined benefit planning going forward.

Mr. Wilson. And Congressman Tierney has already asked some excellent questions on this, but Dr. VanDerhei, can you discuss the benefits and possible disadvantages of retirees taking an annuity payout instead of a lump-sum distribution?

Dr. VanDerhei. Well, my primary argument, just based on the assimilations that I discussed earlier for Massachusetts and the ones that we have done for Kansas, is that individuals have a tendency to spend what they need out of lump-sum distributions not to scientifically try to determine how they should spread that over their lifetime. That may work fine for people who don't have health care costs that aren't expected or catastrophic health care costs such as nursing home care, but we find situations in which once those costs are incurred, if a person does take a lump-sum distribution instead of the annuity, then oftentimes those reserves are going to be spent down far, far too rapidly for them to be able to have any sustained standard of living after that point in time.

Mr. Wilson. And Dr. Leary, in your testimony, you state that some of the shrinkage in the number of multi-employer plans is due to the merger of small plans. When these mergers occur, do the participants of both plans receive notice of the merger? If so, what information is contained in the notice?

Mr. Leary. Yes, they do receive a notice. The provisions are set out in Department of Labor regulations. It provides them with all of the information about the plan that they would be going into. It also provide them with an opportunity to comment, provides them with the opportunity to seek additional information, and it also, and probably most importantly, advises them that the accrued benefit they have at the point of the merger in their old plan will be guaranteed in their new plan. So they are both fully protected and well-informed regarding the plan into which they are going to move.

Mr. Wilson. That seems very helpful.

And Mr. Gebhardtsbauer, one of the jobs of an actuary is to help employers know when and how much to contribute to their defined benefit plans. Can you tell us how you determine what employers must contribute? What kind of assumptions do you use? How have funding obligations changed over the past couple of years?

Mr. Gebhardtsbauer. That is a great question, because it is changing a lot now. At one time you could set your formula and say I want a pension plan that is this generous; I want to spend this much, and the actuary would say this size benefit can be afforded by this kind of contribution. But now interest rates are much lower. And interest rates are just one of the assumptions the actuary has to forecast for what we think the future is going to bring. But because these interest rates are much lower now, the pension funds aren't going to earn as much money, so now you have to put a lot more into the pension plan than you ever intended to maintain that same pension plan from

before.

Now, as Jack mentioned, there is the concern, and the rules enforce this, that you fund pension plans while the employees are working so that by the time they retire you have enough money to pay for their benefits. If you are in a situation where an industry is shrinking, that is a good thing to have happen because it is very difficult to fund that later, when there are fewer workers now than in the past. So you want to fund before people retire, while they are working.

Mr. Wilson. And one final question, Mr. Chairman.

As you are assuming interest rates, can you tell me what your assumption is say for the next 10 years?

Mr. Andrews. And all of you can supplement the record in writing on that.

Mr. Wilson. Some of us want to make an investment.

Mr. Gebhardtsbauer. This is good. You will forget you asked me this question. Actually, actuaries don't make assumptions over the next 10 years; we actually make forecasts over a much longer period. That pension plan is going to last for a very long time. But if I was to make a prediction based on interest rates, most people would say that it is going to be pretty close to where interest rates are today; that we don't know if they are going to go up or down. You don't want to be market predicted, so you assume that the markets are telling you where interest rates are going to be today. And it looks pretty low.

Mr. Wilson. Thank you.

Thank you, Mr. Chairman.

Chairman Johnson. Dr. VanDerhei, can you tell me, do you have any percentages on how many of those plans that are lump-sum can be converted to payout over long term?

Dr. VanDerhei. The most recent figures are from 2000. And we don't know how many plans, but we know how many participants. And 43 percent of all defined benefit participants are in plans that did offer lump-sum distributions. That is quite an increase. It was 23 percent in 1997, and only 14 percent in 1991.

Chairman Johnson. But do they ever opt to pay those out over long term instead of taking the lump-sum?

Dr. VanDerhei. Do the employees?

Chairman Johnson. Yes. How many of them? Do you know the percentage?

Dr. VanDerhei. The only figures I have seen is a Watson Wyatt study back in 1998 that primarily said that, if you give them the option, the vast majority will take advantage of it.

Chairman Johnson. Taking the lump-sum?

Dr. VanDerhei. Yes.

Chairman Johnson. That is what I was afraid of.

Yes, sir. You want to make a comment?

Mr. Gebhardtsbauer. Yes, just to add to that. I have some good news, and that is that people who are closer to retirement are more likely to take the annuity. And so the area that we need to be most concerned about are the ones that most need to take the annuity. But we also need to be able to figure out ways in which we can encourage the younger people to also either keep their money in the pension plan or roll it over and eventually annuitize.

Chairman Johnson. So those that take the lump-sum are generally in the 50 year old age category.

Mr. Gebhardtsbauer. I was thinking under 50. I just became a member of AARP.

Chairman Johnson. Well, how come you didn't retire? Thank you.

Mr. Wu, would you care to question?

Mr. Iwry. Mr. Chairman, might I add something?

Chairman Johnson. Certainly.

Mr. Iwry. In response to your question, the lump-sums that are spent, that are consumed and not rolled over and saved, are particularly those that are very small and that are forced out of the plan by the employer. That is, $5,000 or less.

Chairman Johnson. By the employer changing plans?

Mr. Iwry. No. Just the employer typically has a provision that says, if your benefit is worth $5,000 or less in terms of its present value, we will just cash it out and send you a check, because we don't want to hold this very small account for administrative cost reasons. Those tend to be consumed and not saved. There is a provision in the law now that the Department of Labor is supposed to be implementing. They are writing rules that won't take effect until they finished writing rules that would require those to be rolled over if the employee doesn't indicate that they actually want the check.

In other words, the default, the automatic mode would be that if the employee doesn't say affirmatively, yes, give me the money, I know what I am doing, it would be rolled over to an IRA

by the employer, an IRA that it sets up for that employee. So we would get a lot less leakage of lump-sums that are most likely now to leak out of the system. I think Mr. Andrews has supported that or a version of it in legislation that he has proposed.

Chairman Johnson. Is Labor going to be any faster than Treasury in getting us a response?

Mr. Iwry. I think that Labor is actively working on this. And, of course, any encouragement that the Committee chooses to give them I am sure would be beneficial.

Chairman Johnson. Thank you. I appreciate that comment.

Mr. Wu, you are recognized for five minutes.

Mr. Wu. Thank you very much, Mr. Chairman.

I just want to hone in on one issue which you asked about, and I believe the two prior questioners and also perhaps earlier Mr. Andrews asked about. Before I came here, I didn't deal with anybody I knew of who had a defined benefit plan. Everybody had defined contribution plans. And one of the big challenges is that when there is a rollover opportunity, there is a tendency to spend the money when you have your hands on it. And I believe that you all have been talking about this leakage phenomenon in the defined benefit context a good deal.

Whether you all can address it in a defined contribution or defined benefit context, can you help me out with some statistics, or supplement the record later on with statistics about what percentage of folks wind up, to use a short phrase, not doing the right thing? In essence, not providing for the long term? Apparently, if you just aggregate the numbers and look at large versus small disbursements, you might get different phenomena. But I would just like to invite the panel to address that challenge, whether it is from a defined benefit or defined contribution perspective with gross aggregate numbers. You know, how many people are going to stay in and take care of the long-term future versus go to Mexico and the horse races now?

Chairman Johnson. They all shook their heads yes. And any one of you may speak, or all of you.

Dr. VanDerhei. Well, I could just quickly add that we did a study for the National Association of Social Insurance back in January 2001 that not only has those numbers as inputs but simulated what would be the policy impact of basically putting constraints on at least first order, because obviously there is going to be some planned design impact if you do that. But I would be more than happy to send you that study, because we looked both from a defined contribution and a defined benefit study standpoint that, if you in essence plug those leakages, how much more retirement income would be available. I would be more than happy to send that to you.

Mr. Wu. I would be very interested in that. Can you just spout any quick numbers now, or would you prefer to keep that in the longer explanatory form?

Dr. VanDerhei. For defined contribution, which is primarily 401(k)s, it wasn't as large as most people probably would think. And this goes back to some of the previous comments that it is

primarily the small lump-sum distributions that are being consumed instead of being rolled over. When I say they are being saved, we are looking at it from a total standpoint DB, DC, and IRAs, figuring that that is all going to be there for retirement. I believe it did not make double digits.

On the other hand, if you plug all the holes including, and this is a big, big assumption, money rolled over to IRAs that has to be left in the IRA until retirement, there is a much, much bigger impact. It was well into the double digits as far as average retirement income.

Mr. Gebhardtsbauer. I don't have specific numbers, but I do have a paper on why sometimes people don't choose annuities. And there are quite a few reasons. For instance, they don't think they are going to live that long, and so they want to do it. But just as Jack has said, and I will go further than that, doing it yourself is not as good as doing it through an annuity, because if you do die early, the income doesn't go to yourself, it goes to someone else. And so if you want to maximize the amount of money that goes to yourself in retirement, the best way to do it is with an annuity. That way, everybody can have more income. And I have some graphs that show that; you know, Jack was talking about doing it in scientific ways.

For instance, one way would be to say predict when you think you are going to live to, your life expectancy. Say you live 20 years, to age 85. If you live beyond your life expectancy, and half the people do, then they are not going to have anything after age 85. If you are a little more scientific, you can do something called the minimum required distribution. It is something we have. But again, once you hit your life expectancy, the amount of the money that you pull out of that lump-sum every year starts going down. And in addition, when you do it yourself, you have investment risks. And a lot of people pulled out lump-sums in 1999 thinking it was the right thing to do, and now they have much less money and realize that wasn't a smart idea.

So Jack has mentioned the investment risk and the mortality risk. There is an additional factor that is affecting it, too, and that is tax advantages. The tax advantages are actually going in a direction away from encouraging annuities towards doing the investing yourself. And so having a pension plan and having an annuity are partially dependent on the tax advantages you get through having the annuity or the tax advantage.

And so if those advantages decrease, then there will be fewer people. There will be more paper saying that the annuity is not as good an idea, you should do it in other ways. And so there are different ways to counter balance that by possibly giving advantages to selecting an annuity. And so there are various things that you might think about in government policy. And not only is it helpful to the individual to take the annuity, but it also could be justified for the government because there are less people in poverty later, too.

Mr. Wu. Mr. Chairman, if either of the other witnesses has something to say, can we let them answer?

Chairman Johnson. Quite welcome to.

Mr. Leary. Just very briefly, it does not arise, particularly in the multiemployer defined benefit context, because those plans do not provide for lump-sum distributions except in very limited

circumstances, such as a death, prior to retirement.

However, one of the behaviors that I have seen, and this is quite common, is if a participant is in both a multiemployer defined benefit plan and in a defined contribution plan where they have an individual account, people in those circumstances will see the defined contribution plan as a bank account in many respects and are able to withdraw it either as a hardship withdrawal or with many plans you can withdraw if you separate from employment covered by the plan for a period of time. There is not an age requirement. And the behaviors there are not the behaviors of retirement planners; they are behaviors of people looking to obtain a sudden infusion of income. Now, one reason why they will do that is because they think, I have this defined benefit plan behind me that I can touch.

Thank you.

Mr. Iwry. Mr. Wu, I would suggest that one factor here is that the statistics on lump-sum distributions and rollovers versus consumption have not, in the past, always included money left behind in the plan. A lot of people who are entitled to a distribution have the option of leaving the money in the plan, and some of them do that. That is continued saving as opposed to taking the money out and consuming it. I know Jack VanDerhei's numbers would take into account that kind of a factor, but some of the statistics that have been used in other contexts in the past have not taken that into account.

But in the broader context, I think as you look at lump-sum policy and anti-leakage policy, the two most important things that Congress can do now to improve retirement security in this context and in the context of defined benefit plans generally are probably to solve this funding problem that we have been discussing in a way that gives relief promptly but does not provide for a lump-sum shrinkage, does not cut down the amount of lump-sums in any unreasonable manner. And, second, to solve the cash balance issue. Which is one that has been polarized thus far, but I think can be solved with a middle-ground approach that gives older workers reasonable transition protection and gives employers reasonable flexibility to convert the cash balance plans and to choose exactly how, but not whether, to provide that transition protection.

Mr. Wu. I thank you for your helpful answers, and I look forward to receiving any written materials that you would care to send. I am very interested in that.

And thank you very much, Mr. Chairman.

Chairman Johnson. Thank you, Mr. Wu. Those were good questions.

I want to thank the witnesses and the Members for their time today, and I want to congratulate this panel. I think this is one of the more astute and knowledgeable panels that we have had present before us, and I thank you all for your time.

We are going to have votes here within five or ten minutes, so if there is no further business, we will adjourn. Does anyone have any comment? Hearing none, the Subcommittee

stands adjourned.

Whereupon, at 3:36 p.m., the Subcommittee was adjourned.

APPENDIX A - WRITTEN OPENING STATEMENT OF CHAIRMAN SAM JOHNSON, SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS, COMMITTEE ON EDUCATION AND THE WORKFORCE

Opening Statement of Rep. Sam Johnson (R-TX),
Chairman, Subcommittee on Employer-Employee Relations

Hearing on "Strengthening Pension Security:
Examining the Health and Future of the Defined Benefit Plan"

June 4, 2003

Good Afternoon and welcome to the Employer-Employee Relations Subcommittee.

Today we will begin a series of hearings on the challenges that face the defined benefit pension system.

I'll be listening with particular interest to the testimony regarding the pension funding crisis. This hearing will build on our efforts over the last several years to enhance retirement security and expand pension coverage to millions of American workers. After the success of passing H.R. 1000, the Pension Security Act, that mostly deals with the defined contribution system, we now turn our attention to the issues and concerns facing the defined benefit pension system.

Giving workers as many retirement security options as possible should be our goal, and we should encourage employers to offer both 401(k) accounts <u>and</u> defined benefit pension plans to their employees.

While the Committee is interested in the general structure and mechanics of defined benefit pension plans, we are even more interested in examining the various complex matters about sponsoring, funding, and providing benefits under this system.

In particular, we are concerned with the staggering decline in the number of traditional pension plans over the last several years.

We are going to examine the various reasons that plans have been frozen or terminated.

I firmly believe that over the years, layers upon layers of red tape and over-regulation have strangled these plans and driven them nearly to extinction. We will also examine the current funding issues facing many employers and plans today.

We should be seeking the correct level of funding for these plans. We must be sure the money is available to pay for these promised benefits when workers retire. These plans are backed up by Pension Benefit Guaranty Corporation insurance and American taxpayers. We need to make sure that U.S. taxpayers aren't left holding the bag for private-sector promises.

However, we must be careful to not require over-funding, which is an unnecessary drain of corporate resources that may cause employers to consider eliminating plans.

Besides being crucial to individuals' retirement security, pension plans are an important resource for employers in order to maintain employee talent and dedication. Today, we will hear from four witnesses with expertise in the pension industry who can tell us about defined benefit plans and the health and future of the system in general.

I am hopeful that the witnesses will be able to enlighten the subcommittee on the role defined benefit plans play not only in providing retirement security for workers...but in providing employers with a powerful tool for recruiting and retaining a valuable and competitive workforce. From the witnesses' testimony today, I think we will all be better able to understand the complexities of our defined benefit pension system and the challenges currently facing that system today.

APPENDIX B – WRITTEN STATEMENT OF JACK L. VANDERHEI, Ph.D., FACULTY MEMBER, FOX SCHOOL OF BUSINESS AND MANAGEMENT, TEMPLE UNIVERSITY, PHILADELPHIA, PA, AND RESEARCH DIRECTOR, EMPLOYEE BENEFIT RESEARCH INSTITUTE (EBRI) FELLOWS' PROGRAM, WASHINGTON, D.C.; TESTIFYING ON BEHALF OF EBRI

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Subcommittee on Employer-Employee Relations

Committee on Education and the Workforce
United States House of Representatives

Hearing on

Strengthening Pension Security:
Examining the Health and Future of Defined Benefit Pension Plans

Testimony of

Jack L. VanDerhei, Ph.D., CEBS
Temple University and EBRI Fellow

Washington, DC

June 4, 2003

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Witness Disclosure Statement,
pursuant to Clause 2(g)(4) of Rule XI of the Rules of the House:

- **The Witness:**
  Jack VanDerhei is a faculty member at Temple University's School of Business and Management (Department of Risk, Insurance, and Healthcare Management), and also is Research Director of the Employee Benefit Research Institute (EBRI) Fellows' Program, Washington, DC. EBRI is a private, nonprofit, nonpartisan public policy research organization based in Washington, DC. Founded in 1978, its mission is to contribute to, to encourage, and to enhance the development of sound employee benefit programs and sound public policy through objective research and education. EBRI does not lobby and does not take positions on legislative proposals.

- **The Organization:**
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STATEMENT BY Jack VanDerhei

Temple University and EBRI Fellow
June 4, 2003

Mr. Chairman, and members of the Committee. I am Jack VanDerhei, Temple University and research director of the EBRI Fellows' Program.

It is my pleasure to appear before you today to discuss Strengthening Pension Security: Examining the Health and Future of Defined Benefit Pension Plans. I will address that topic by providing some background, context, and recent research on "DB" pension plans, as well as current trends.

An Overview of the Defined Benefit Pension Plan System[1]

Introduction

A defined benefit (DB) plan is a retirement plan in which benefits are calculated according to a formula or rule. Formulas are more common and are usually based on either years of service and a percentage of pay or a negotiated flat-dollar amount (Allen et al., 1997). Benefit levels, as determined by the formula used, are guaranteed as a stated retirement income commencing at a specified age. Although retirement benefits are usually expressed as a life annuity,[2] lump-sum distributions are increasingly available. While DB plans are always designed as retirement vehicles, certain defined contribution (DC) plan types and designs have features that resemble capital accumulation plans (i.e., plans used for savings, not necessarily for retirement). Traditionally, DB and DC plans have different features associated with each. For example, DB plans usually pay benefits in the form of life annuities, whereas DC plans typically pay lump-sums. However, one fundamental difference between DB and DC plans exists. Under a DB plan, a formula guarantees the final benefit level; in a DC plan, a formula stipulates how funds are allocated to individual accounts.[3] Because so few fundamental differences exist between plan types, employers have significant leeway to design individual plans tailored to their specific objectives. Recently, an increasing number of employers have used this leeway to combine traditional DB plan features with features usually associated with traditional DC plans, and vice versa. (Many of these arrangements are called hybrid plans, and are discussed later.) As a result, the difference between DB and DC plans is becoming more nebulous.

Benefit Calculation and Plan Funding

When establishing a DB plan, employers usually choose between flat benefits and pay-related benefits. A *flat benefit formula* bases benefits on a flat-dollar amount for each year of service recognized under the plan (e.g., $400 in annual retirement multiplied by years of service).[4] Pay-related benefits can be divided into two variations, based on the definition of pay. *Career-average formulas* define pay as all earnings during plan participation in order to calculate benefits. *Final-average formulas* define pay as only those earnings received during an averaging period just prior to retirement. *Career-average formulas* have two variations. Final retirement benefits can either equal: (a) the sum of a percentage of salary earned each year recognized by the plan (e.g., the sum of 2 percent of annual pay for each year of service) or (b) the average of all annual salaries recognized by the plan multiplied by a percentage (e.g., $30,000 in average pay multiplied by 50 percent).[5] DB plans typically retain an actuary to annually assess plan obligations based on the plan's specified formula and to determine the amounts the plan sponsor should place in the pension fund in order to comply with funding requirements. (These amounts are based on the selected actuarial valuation method and appropriate actuarial assumptions.) The plan sponsor is then ultimately responsible for making required contributions as well as ensuring that the fund's assets are invested and benefits are paid; however, these responsibilities are often delegated to third parties. Although it is

uncommon, private-sector workers may have the option of contributing to the DB plan as well, but their contributions are not given tax-favored status.[6]

Retirement Income Risk

There are many risks associated with participants' assets in retirement savings vehicles:[7]

1. Replacement rate inadequacy.
2. Longevity.
3. Investment risk.
4. Inflation risk.
5. Private plan sponsor bankruptcy risk (for DB plan benefits in excess of Pension Benefit Guaranty Corporation [PBGC]-covered maximums).

Replacement rate inadequacy risk deals with the possibility that the combination of Social Security, employment-based retirement income, and individual savings will be insufficient to maintain the same standard of living a preretiree enjoyed when he or she retires. While in the past this risk could be caused by financial instability of an employer sponsoring a private pension plan, today PBGC will pay benefits (subject to prescribed limits) for most private DB plans[8] whose sponsors are unable to meet plan obligations due to bankruptcy. As a result, plan sponsor bankruptcy risk among private plans today is limited to the risk of losing benefits above the amounts guaranteed by the PBGC, should the employer go bankrupt.

The second risk—***longevity risk***—can be defined in several ways. One definition (Bodie, 1990) defines it as the risk that the retiree will outlive the amount saved for retirement. A primary rationale for paying retirement plan benefits in the form of life annuities is to insure against this risk. Hence, this risk can be insured against through either the DB or DC approach only if benefits are paid in the form of an annuity or if participants effectively self-annuitize.[9]

The third risk—***investment risk***—is a relatively straightforward (albeit often misunderstood) concept. While many equate this term with variation in retirement benefits resulting from fluctuations in the financial markets, investment risk may also refer to the risk that investments will underperform the rate of return needed for sufficient retirement income. Indeed, underperformance may arise from down-side fluctuations in financial markets, but it also stems from investing in low-risk assets that do not earn adequate return rates. While a DB plan offers no direct investment risk to participants,[10] the amount of this risk participants are exposed to under a DC approach is often misunderstood. Many assume that DC investments are risky because asset allocation choices may be subject to wide market fluctuations. However, many DC plan sponsors provide guaranteed investment contracts (GICs) and/or stable value funds as investment options, which provide some degree of assurance that participants' investments will not decline in value. While many might assume that these options entail no investment risk for participants because the principal will typically not decline by more than a de minimis amount, choosing such investments may entail investment risk if the rate of return on these investments is lower than that needed to grow a sufficient retirement nest egg.

The fourth risk—***inflation risk***—can only be directly addressed by the plan sponsor in DB plans, and is perhaps the most difficult to deal with in the private sector. Social Security and many of the public DB pension plans have the perceived resources to commit to some type of guarantee that inflation's impact on the purchasing power of this component of retirement income will be mitigated.[11] However, private sponsors generally have not been able to cope with this problem other than to hold out the possibility of providing ad hoc increases in pension payments on a somewhat periodic basis.[12]

Issues Concerning Sponsoring, Funding, and Providing Benefits to Participants and Beneficiaries Under This System

Employers' Accounting For Pensions

Employers must recognize the economic value of future promises in their financial statements. Income statement accounting affects reported earnings, and this affects profitability and the value of the company. Balance sheet accounting affects the employer's liability and assets, thus the net worth of the enterprise and its ability to borrow money. In short, accounting for benefit promises as they are earned, rather than only when they are paid (or when the contributions are made), has significant economic implications and implications for employer decision on whether or not to provide defined benefit plans.

Accounting procedures for pension plans consist of three components, each of which is controlled by a separate Financial Accounting Standards Board (FASB) Statement. FASB Statement No 35, *Accounting and Reporting by Defined Benefit Pension Plans*, establishes financial accounting and reporting standards for the annual financial statement of a defined benefit pension plan. FASB Statement No. 87, *Employers' Accounting for Pensions* (FAS 87) establishes financial reporting and accounting standards for an employer that offers pension benefits to its employees. Closely related to FAS 87, FASB Statement No. 88, *Employer's Accounting for Settlements and Curtailment of Defined Benefit Pension Plans and for Termination Benefits*, establishes standards for an employer's accounting for settlement of defined benefit pension obligations (such as purchasing annuities for retirees), for curtailment of a defined benefit pension plan (e.g., closing of a plant), and for termination benefits.

While the impact of the statements has come under considerable criticism in the financial press recently as the bear market caused increasing skepticism with respect to the reported numbers, it is important to realize that FASB's objectives when the rules were designed in the 1980's was to inject into pension accounting a way to more meaningfully measure pension expense and to introduce balance sheet items (including footnotes) helpful to financial statement readers.[13] The overall impact of the rules varied among employers depending on plan design, the age of the work force, actuarial assumptions, and the plan's financial status at the time of transition to the new rules. Nevertheless, it appears safe to say that the latitude for management discretion in pension accounting was greatly reduced. The sponsor is no longer able to choose an actuarial cost method that provides the desired stream of pension expense over time and the range of acceptable discount rates for determining the present value of pension obligations was implicitly narrowed.

It appears that a current concern with respect to FAS 87 is its lack of transparency for at least some investors.[14] In an attempt to improve investor understanding of corporate earnings reports, Standard & Poor's (S&P) released a set of definitions last year to be used in generating core earnings figures. The definitions include pension costs but exclude pension gains. S&P's rationale for this asymmetric treatment was:

> Some may be concerned that pension income is excluded from Core Earnings, while pension costs are included. This apparent conflict is in reality no conflict at all. The two are not parallel because they arise in different places from different activities. Pension costs are part of employee compensation and arise because people are hired to work and, hopefully, produce revenues and Core Earnings. Pension gains, in contrast, have nothing to do with the corporation's core business or the creation of Core Earnings. The size and timing of pension gains reflect the skill of the portfolio managers engaged to manage the pension plan and the foresight of the pension plan sponsor in establishing the investment policy and hiring the portfolio managers. Both the gains and the costs are related to the pension, but the similarity ends there. (Blitzer, Friedman, Silverblatt: 2002.)

In March of this year the FASB decided to add to its agenda a limited-scope project intended to improve pension plan disclosures. While this procedure may yield draft rules in a few months, FASB opted not to embark on a comprehensive project on pension accounting that might have entailed substantive modification of the smoothing mechanisms in FAS 87 (Burkholder, 2003). However, the future of U.S.

pension accounting and its impact on plan sponsorship may be influenced by international standards. In 2001 the United Kingdom adopted FRS 17, a standard that will put the market value of pension plan assets and liabilities on the corporate balance sheet. Under this standard, gains and losses are recognized as they occur, rather than held off the balance sheet and amortized as they are under FAS 87.[15]

Although a certain amount of experience gains and losses are allowed to be deferred under a combination of a corridor approach as well as gradual amortization of amounts outside of the corridor under FAS 87, some companies are said to have attempted to control this volatility by shifting asset allocation away from stocks to more stable investments that would allow some degree of immunization[16] against movements in interest rates. A disadvantage of this strategy is that the sponsor gives up the opportunity to produce additional investment income (assuming a positive equity premium) for the plan that can help reduce future pension contribution and/or provide for increased pension benefits.

If all smoothing devices for pension accounting were eliminated, the relative advantage of sponsoring defined benefit plans would likely decrease for some sponsors as they would either be fearful of the increased volatility in the pension expense and/or need to increase expected contributions in the future if they assume a less risky asset allocation.

Funding Requirements

Qualified defined benefit plans must satisfy a complex set of minimum funding requirements that have been adopted by Congress in an attempt to assure that the vast majority of plans will have sufficient assets to pay the promised benefits when they become due.[17] A detailed description of these requirements is beyond the scope of this testimony but several recent papers provide excellent background on funding requirements (Joint Committee on Taxation, 2003), the financial condition of the Pension Benefit Guaranty Corporation and possible reforms (Kandarian, 2003), and problems in pension funding rules due to Treasury bond rates becoming inordinately low (Gebhardtsbauer, 2003; O'Flinn, 2003; Eickelberg, 2003).

There is no doubt that recent reports paint a gloomy picture of the financial health of the single-employer defined benefit system. In fact a report released last month by Wilshire (Nesbitt, 2003) proclaimed that corporate pension funds suffered their worst year ever. Based on 10K filings from 320 companies in the S&P 500 Index that maintain defined benefit plans, the ratio of assets to liabilities fell from 104 percent to 83 percent with 89 percent of the sponsors now underfunded.[18]

While these numbers have caused concern for the future of the single-employer defined benefit system, there are three points that need to be considered when contemplating a legislative reaction:

1. The self-correcting mechanisms in the pension funding requirements have already come into play with aggregate contributions for these plans increasing from $12 billion in 2001 to $41 billion in 2002.
2. One needs to keep in mind that the "perfect storm" scenario of a sustained three-year bear market coupled with abnormally low interest rates is an extremely unusual situation and a convincing argument could be put forth that this would not be the proper baseline to use to establish new federal requirements with respect to pension funding.
3. An underfunded plan is not a problem as long as the sponsor remains financially solvent.

One obvious solution to the problem of insufficient funding that has at least temporarily been adopted is the repeal of the full-funding limit for plan years beginning in 2004 and thereafter.[19] The full-funding limit has been in effect since ERISA and has provided a maximum limit on the deductible contributions a plan sponsor could make in a year. This was rarely a binding constraint until it was modified by OBRA '87 to add a new requirement: plan assets (as defined in the Internal Revenue Code) could not exceed 150 percent of the plan's current liability (including the current liability normal cost). In essence, this limited the amount of assets to a value based on the plan's termination liability as opposed to an ongoing liability (the former does not project for future wage growth while the latter does, which can produce a significant

difference in final-average plans, especially with a young work force). Although the 150 percent value was eventually increased to 170 percent, it appears that for many plans the cushion would have been insufficient in the face of a three year bear market combined with a sustained drop in discount rates.

While there is little doubt that had these limits not been imposed in the 1980's, many plans would no doubt be better funded today. However if the OBRA '87 full-funding limit was a binding constraint on employer contribution behavior among well-funded plans, one would have expected to see a bunching of plans at the full-funding limitation threshold after the constraint had been in place for several years. Instead, Ippolito (2001) shows that by 1995 there had already been a major shift of plans with funding ratios in excess of 150 percent in 1986 to far less than that value. He hypothesizes that another potentially significant impact on pension contributions for well-funded plans was a series of excise taxes on employers that terminated their defined benefit plans and reverted the excess assets back to the firm after paying the employees their promised benefits. These "reversion" taxes started at 10 percent in 1986 and eventually increased to 50 percent in 1990, meaning that any excess assets would be taxed at about 85 percent (corporate tax plus reversion tax).[20] He estimates the impact of reversion taxes on pension funding, holding constant pension funding limits, plan maturity and other confluences of time trends, and found strong evidence in favor of the reversion-tax theory of defunding.

Cash Balance Plans[21]

The recent trend among large employers toward conversion of traditional final-average and career-average defined benefit plans to cash balances has raised a controversial and complex set of issues. A cash balance plan is a "hybrid" type of pension plan[22]—i.e., one that takes on the characteristics of both a defined benefit plan and a defined contribution plan. Legally, a cash balance plan is a defined benefit plan. A cash balance plan offers some of the popular advantages of a defined benefit plan but is designed to look more like a defined contribution plan, with an individual "hypothetical" account that appears to accumulate assets for each participant. Cash balance plan accounts are a record-keeping feature only, as these plans are funded on an actuarial basis, in the same way that defined benefit pension plans are funded. Therefore, at any point in time, the benefits promised to a participant are based on the plan formulae and not on the assets in his or her "account."

In a typical cash balance plan, a participant's retirement account grows by earning annual credits that may be based on a flat percentage of pay but that might be integrated with Social Security benefits (Quick, 1999). However, it is also possible to provide age or service-weighted pay credits under these plans. Cash balance plans also provide a yield on the hypothetical account that is typically defined as either the 30-year Treasury rate or the one-year T-Bill rate plus a stated percentage (Gebhardtsbauer, 1999).

Fundamental Economic Distinction Between Final-Average and Cash Balance Plans

Under either the final-average or cash balance plans illustrated in Figure 1, an employee starting at age 25 will obtain the same benefit value at age 65 if he or she remains with the same employer for a full career. Nevertheless, the accrual rates under each plan differ fundamentally. The annual increase in benefit value (viz., how much additional retirement income an employee will earn by working one more year) tends to be much higher for young employees under the cash balance plan and much higher for older employees under the final-average plan. This is true even though the cash balance plan illustrated in this figure adopts a service-weighted pay credit schedule.[23]

A difference in accrual rates between older and younger workers upon conversion from a final-average to a cash balance plan is likely to exist whether or not a so-called wear-away provision (explained later) is included in the plan. The difference is conceptually similar to the effects of changing a final-average plan to a career-average plan or, more drastically, terminating a defined benefit plan and establishing a defined

contribution plan. However, the magnitude of the difference is influenced by plan-specific design parameters.[24]

Employees faced with the type of graph shown in Figure 1 are likely to wonder why the shapes look different. The difference essentially lies in the different determinants of benefit value under each type of plan. While the present value of the annual accrual of pension wealth expressed as a percentage of compensation under a final-average plan at any point in time depends on age, service, and pay, it depends predominantly on pay and service (and a lesser extent on age) under a cash balance plan. Therefore, even if the overall generosity of a plan remains the same after conversion to a cash-balance formula, higher accruals for young employees means that accruals for older employees will likely decrease unless some type of grandfathering or transition provisions (explained below) are provided to older workers. For example, an employee participating in the hypothetical final-average defined benefit plan in Figure 1 would have a present value from his or her defined benefit plan at age 55 of approximately $95,000, as opposed to approximately $135,000 for a similar employee who had participated in the hypothetical cash balance plan for the same period of 30 years. However, if the hypothetical final average plan were then converted to the hypothetical cash balance plan without the provision of any type of transition credit, the employee would not benefit from the rapid escalation in pension wealth from age 55 to 65 that is associated with the final average plan. Instead, during the final 10 years he or she would experience a slope of the accrual path similar[25] to that experienced by the participant who remains under the cash balance plan for the entire 40 years. As a consequence, the participant will not end up with the same financial position at age 65 but, barring any transition provisions, would experience a decrease in pension wealth of approximately 23 percent.

Another significant difference between a traditional defined benefit plan and a cash balance plan concerns the inherent uncertainty involved in estimating the nominal amount of retirement income. Traditional defined benefit plans are not typically thought of in this regard since the amount is specified in a formula and (with the exception of certain integrated plans) can be directly computed once the average compensation and years of participation are known. However, it appears that an increasing percentage of defined benefit participants are now receiving their distributions in the form of lump-sum distributions (LSDs) – a form that can provide great uncertainty to employees with respect to the amount that they will receive due to fluctuations in the relevant discount rates (Bone, 1999). In contrast, cash balance plans provide LSDs that are stabilized, but annuity values under these arrangements may be subject to fluctuations in annuity purchase prices although it appears some employers are willing to hold annuity purchase rates constant in the plan (Gebhartsbauer, 1999).

Potential Advantages: Cash Balance vs. Final-Average Plans

Before discussing key public policy issues and the possible ramifications of modifying the existing legislative and/or regulatory landscape, it may be helpful to consider why a sponsor of a final-average defined benefit plan may be interested in converting to a cash balance plan:[26]

Ease of communication vs. invisible plan syndrome. Sponsors of traditional defined benefit plans often bemoan the lack of recognition they receive from their employees, even though substantial sums of money are contributed and/or accrued annually. When the quality of workers' information regarding traditional pension offerings was evaluated,[27] about one-third of workers queried were unable to answer any questions about early retirement requirements, and about two-thirds of those who offered answers about early retirement were wrong (Mitchell, 1988). In contrast to explaining the complex benefit formulas used by traditional defined benefit plans, conveying information through theoretical account balances under cash balance plans facilitates employee appreciation of both current pension wealth and the annual pay and interest credits that increase pension value over time.

No magic numbers of age and service. Final-average defined benefit plans often require employees to satisfy some combination of age and service before they are entitled to retire with an early retirement subsidy, and the magnitude of the dollar loss from leaving prior to that time can be substantial

(Ippolito, 1998). In contrast, the accrual pattern under a cash balance plan typically does not have a sudden, rapid increase after attainment of specific age and service criteria. As a result, cash balance plans are more attractive to a mobile work force.

Higher benefits to employees who do not stay with one employer for their entire career. Figure 2 shows the percentage increases in annual retirement benefits at normal retirement age for an employee in a hypothetical cash balance plan versus a hypothetical final-average defined benefit plan. The figures in this figure are tabulated from a CRS report to Congress that includes calculations for two types of employees: (a) one who enters the employer's plan at age 25 and remains in that plan for 40 years and (b) one who changes jobs every 10 years (Purcell, 1999). Comparing the two sets of bar graphs, one can see that for a hypothetical individual staying at the same job for his or her entire life, the cash balance plan provides a larger benefit after the first 10 and 20 years of service. But, by age 55, the final-average plan is slightly more valuable, and by retirement age the benefit derived from the final-average plan would be 30 percent larger than the cash balance benefit. However, this "one-job-for-life" scenario only applies to a small percentage of the work force (Yakoboski, 1999). Employees are more likely to have four, if not more, jobs during their careers. The second set of bar graphs show that in those cases, the series of cash balance plan benefits dominate those accrued under the final-average plans at every age, and the final retirement benefits are approximately 40 percent larger.[28]

Potential Advantages: Cash Balance vs. Defined Contribution Plans

Of course, an employer that sponsors a final-average plan also has the alternative of terminating the existing defined benefit plan (assuming it is adequately funded) and setting up a defined contribution plan through which to provide benefits for future service. However, several considerations may make this option problematic:

Ease of conversion vs. new plan establishment. Whereas a conversion from a final-average defined benefit plan to a cash balance plan only requires a plan amendment (Rappaport, Young, Levell, and Blalock, 1997), terminating the same plan and setting up a successor defined contribution plan may trigger a reversion excise tax of either 20 percent or 50 percent (Alderson and VanDerhei, 1991). If the defined benefit plan was overfunded, the surplus in a conversion to a cash balance plan would be used to reduce future contributions (as it would under the traditional plan); if it was underfunded, the unfunded liability is amortized in the normal fashion (Warshawsky, 1997).

Guarantee of employee participation. The noncontributory nature of most (if not all) cash balance plans eliminates the need to worry about employees who choose not to participate or make *de minimis* contributions in a 401(k) arrangement (Yakoboski, 1994). As a result, employees are guaranteed a benefit under a cash balance plan without needing to actively choose to participate in the plan, and the plan is protected from possible disqualification due insufficient participation among lower-paid workers.

Retirement pattern predictability. Investment risk is typically directly borne by employers under a cash balance plan and by employees under a defined contribution plan (see Auer 1999, however, for one notable exception). As a result, the employer is better able to predict retirement patterns under a cash balance plan, since retirement income will not be susceptible to market fluctuations. Under a defined contribution plan, employers may face unexpected increases in early retirements during a strong bull market and unexpected delays of retirement during a market correction (especially if it is prolonged).

Retirement benefit predictability. Since employers directly bear investment risk under cash balance plans, they need not worry about overly conservative worker-investors. Figure 3 below shows the 1996 percentage of 401(k) participants with zero exposure to diversified equities by age cohort (VanDerhei, Galer, Quick, and Rea, 1999). Although approximately one-half of these individuals in each age cohort have some equity market exposure through company stock and/or balanced funds, a significant percentage of them may be subjecting themselves to expected rates of return too low to generate sufficient retirement income at normal retirement age.

Funding flexibility. Finally, a cash balance plan may have more funding flexibility than a defined contribution plan, depending on the type of commitment made to employees. Although some profit-sharing plans provide for annual contributions that are entirely discretionary for the plan sponsor (Allen, Melone, Rosenbloom, and VanDerhei, 1997), a defined benefit plan is the only vehicle that will allow employees to continue their normal benefit accruals while employer contributions are reduced or even temporarily curtailed.

Potential Limitations of a Conversion From a Defined Benefit to a Cash Balance Plan

Although using a cash balance plan to provide benefits that are easily communicated, typically provide no investment risk to employees, and maintain the funding flexibility inherent in a defined benefit plan may appeal to many employers, cash balance plans also present several tradeoffs:

Smaller accruals for older workers. As mentioned earlier, unless some type of transition benefits are provided, older employees are likely to receive smaller accruals for their remaining years, regardless of whether a "wear-away" provision (described below) exists.

Preretirement income replacement. Although their understanding of current pension wealth and future increments will no doubt improve vis-à-vis the previous final-average plan, employees actually may be more uncertain about how their future benefits will relate to their future earnings after conversion to a cash balance plan. For example, a final-average plan that pays 2 percent of an employee's average earnings during his or her last three years of service, by definition, replaces 50 percent of preretirement earnings after 25 years of service.[29] However, to understand the extent to which cash balance benefits will replace preretirement earnings is far more difficult, since cash balance plans are a type of a career-average formula that provides interest credits that are likely tied to some external financial market vehicle and/or index.

Lump-sum distributions. Due to the increased likelihood that participants in a cash balance plan will end up with a LSD as opposed to a lifetime annuity, it is more likely that they will face a longevity risk in addition to a post-retirement investment risk. It should be noted, however, that with some exceptions, cash balance plans are required to offer annuities as an option to their participants, and it appears that there is an increasing propensity for traditional final-average defined benefit plans to offer LSDs and for participants to choose them when offered (Watson Wyatt, 1998). Also, even though cash balance plans communicate benefits in terms of a lump-sum account balance, at least some of them limit the ability of employees to cash out their accounts.[30]

Key Issues

In recent years, there has been a flurry of press accounts, court cases, and legal and regulatory activities with respect to cash balance plans, specifically as they relate to conversions from existing final-average plans. This section of the testimony provides some insight into each of these in an attempt to clarify some of their more complex and controversial concepts.

Do Cash Balance Plans Result in Cost Savings to the Sponsor and/or Benefit Reductions to the Participants? It is certainly possible for conversion to a cash balance plan to result in lower *long-term* pension expense, depending on the generosity of the new plan relative to the existing plan. In essence, this is no different than switching from a defined benefit to a defined contribution plan, and similar projections would need to be applied to determine if this were the case (VanDerhei 1985). However, even if such a calculation was performed on two retirement plans, it would not necessarily indicate the extent of cash balance savings, if any, since any savings due to cash balance plan conversion may be offset by other increases in benefits or compensation.[31]

Assuming such a calculation was performed, the cash balance plan may also prove to be more expensive than originally calculated if turnover is higher than assumed. This would result from plan assets being reduced below expected levels, and the spread between the accrual in the plan and the actual fund performance may be a factor in increased costs.[32] Turnover could increase due to future labor patterns

that impact all employers, but it might also increase as a direct consequence of providing a more level benefit accrual over time that decreases the "job lock" attributes of the existing plan.

However, there may also be *short-term* abnormalities in the pension cost and/or expense structure resulting from the conversion. In essence, the claims of cost savings from a conversion to a cash balance plan may be at least partially due to a timing issue under the accounting and/or funding rules required for all defined benefit plans (including cash balance plans). Although the calculations are complex, one of the driving forces behind this short-term cost reduction involves the computation of the cost of accruing a benefit based on career-average pay (the cash balance plan) for one based on final-average pay under the previous plan (Demby, June 1999).[33]

Brown et al (2000) classified employers who shifted from traditional pensions to hybrid plans into three groups: cost reducers, cost neutral shifters, and cost increasers. When looking at the changes made only to defined benefit plans, they found that 56.4 percent of the plans they studied fell into the cost reducing class; 20.5 percent adopted changes that were cost neutral; and that 23.1 percent increased their pension cost in the shift to hybrid plans. Next, they considered changes made to plan sponsors' defined contribution plans adopted in conjunction with the shift to a hybrid plan. Adding in these changes, they found that 44.9 percent of sponsors reduced costs in the shift to their new pension package, 17.9 percent adopted changes that were cost neutral, and 37.2 percent adopted changes that increased costs. On average, they found pension costs were reduced by an average of only 1.4 percent in the shift to the new package

Clark and Schieber (2000) demonstrate that a significant portion of benefit reductions that do occur result directly from eliminating early retirement subsidies.[34] Figure 4 shows the effects of the shift to hybrid plans for three hypothetical workers. In every case reflected in the figure, the majority of the hybrid plans reduced benefits for the prototypical workers by less than the amount of the reduction that would have occurred if they had simply eliminated their early retirement subsidies. For any of the cases where the worker is assumed to retire at age 55, less than 16 percent of the plans would reduce benefits by more than the elimination of the early retirement subsidies.

Transition/grandfathering. Several transition methods are available to a sponsor that chooses to mitigate the financial impact that may result in a switch from a traditional final-average plan to a cash balance plan (Rappaport, Young, Levell, and Blalock, 1997):

- Pay the greater of the benefit that would have been paid under the old plan and the benefit due under the new formula for a subset of the employees (either for a limited time period or until termination or retirement).
- Provide extra account balances at transition to make up for the greater benefit which would have been available at early retirement.
- Provide extra account balances to make up for the fact that final-average earnings will not be directly used in the formula.
- Provide a supplemental additional benefit.

A PricewaterhouseCoopers survey of about 75 cash balance conversions reveals that in almost all cases the employer provided transition provisions beyond the legally required minimums (Sher, 1999).

In 88 percent of the plans examined in Clark and Schieber (2000), the plan sponsor provided some form of transition benefit for some workers affected. Figure 5 shows the potential effect that hybrid plan conversions would have had on workers who were 50 years old at the time of conversion with 25 years of service under their old plan. Distributions of the benefits as a percent of prior benefits that would have been payable at various ages under the pre-conversion plans are presented for three different retirement ages (55, 60 and 65) for estimates with and without the transition benefits. The transition benefits provided in the shift to hybrid plans appears to significantly mitigate the adverse effects of the plan changes. For example if this stylized worker retired at age 55, there would have been a reduction for

nearly 80 percent of the plans without a transition benefit; however, this number decreases to 34 percent when the transition benefits are included.

Wear-away. If a final-average plan is converted to a cash balance plan, the initial value of a participant's cash balance account *may* be set at less than the value of benefits accrued under the previous plan. However, it is important to note that this may not reduce or take away previously earned benefits. It may mean, though, that *initially* some workers won't accrue any new benefits until the pay and interest credits to their hypothetical accounts bring the account balances up to the value of the old protected benefits.

While most press coverage of wear-away has focused on its potential duration, Clark and Schieber (2000) point out that the rate of wear-away is also important and they compute the potential cumulative wear-away as a percentage of pay at base age for a stylized individual under two scenarios: (1) a transition to a hybrid plan at age 54 and (2) that which inherently exists in a traditional plan age 55. Figure 6 shows the cumulative distribution function of the potential cumulative wear-away based on their computations. In nearly half the cases, employers structured the new plans to make the wear-away issue moot. In the remaining plans, the cumulative wear-away that workers faced was generally not as great as it was in the prior plans being replaced.

As pointed out in testimony to the ERISA Advisory Council Working Group studying hybrid plans, benefit formulae that end up resulting in periods with no new accruals for some employees have been a practice approved by the Internal Revenue Service for many years (Chambers, 1999). Often plan changes, such as updating plan mortality assumptions, the resultant standardization of disparate pension plans as a result of mergers and acquisitions, or even revising a plan to meet new statutory requirements (such as legislative changes to the Sec. 401(a)(17) limits earlier this decade) can result in periods without new accruals.

Disclosure requirements. Recently, some have argued for the need to disclose to each employee the differences in his or her accrued benefits under the previous plan formula and his or her initial account balance under the cash balance plan. Moreover, they have argued that the wear-away period (if any) during a conversion should be explained, and a meaningful comparison should be provided to each worker of projected benefits under the amended plan compared with benefits that would have been earned under the previous plan formula. This appears to be based on a belief that it is critical for plan participants to have an appropriate opportunity to (a) voice their concerns regarding plan amendments so that employers are fully aware of them and (b) alert regulators to issues surrounding cash balance conversions that they deem important (White, 1999).

However, others in the pension policy community have questioned the logic in providing estimates under a benefit plan that no longer exists and have warned that Congress should proceed very cautiously in adding to the already substantial burdens of administering a cash balance or other defined benefit plan (Metras, 1999). Employers may be unreceptive to projecting future benefits due to the extremely sensitive nature of the estimates.[35]

Importance of Pooling of Longevity Risk

Although defined benefit plans are not necessarily more or less generous than their defined contribution plan counterparts with respect to the amount of wealth generated by retirement age for an individual employee, there are fundamental differences in the payout stage at least for those defined benefit plans that do not offer lump-sum distributions to their employees at retirement. When defined benefit payouts are offered in the form of an annuity to all retirees, two of the risks mentioned in section one of this testimony are retained by the employer instead of being transferred to the employee: investment risk and longevity risk.

The value of the investment risk transfer is well known as is the fact that defined benefit plans (when not taken in the form of lump-sum distributions) eliminate the risk of outliving your income; however, there

does not appear to be any quantitative assessment of how important the latter might be. In this section, the value of longevity risk transfer is simulated based on mortality rates, the amount of retirement income and wealth the individual has at retirement, and the projected expenditures in retirement. Retirement income and wealth for residents of the state of Massachusetts born between 1936 and 1965 are projected to age 65 and then paid out in one of two methods. In each case, retirees are assumed to earn monthly Social Security benefits under the current system (i.e., no Social Security reform is assumed) as well as any defined benefit monthly payments that may be accrued from their employers. They will also accumulate individual account balances from defined contribution plans, cash balance plans, and IRAs (both from regular contributions as well as rollovers). The simulation model also estimates the value of net housing equity, if any, at age 65.

Once individuals reach age 65, they are assumed to retire and in each year for the remainder of their lives, the model simulates whether they continue to live another year and, if so, what their expenditures will be for the year. Retiree expenditures are assumed to be both deterministic (the amount spent on housing, utilities, etc. each year is assumed to be known and will be a function of the retiree's income, family status, and location) and stochastic (e.g., in most years the retiree will not require nursing home care; however, for years when it is simulated to be utilized the amount spent on this service could be catastrophic in value).

In the baseline case, it is assumed that all defined benefit plan benefits are paid in the form of an annuity while individual accounts are spent as needed to pay the simulated expenses. It is assumed any account balances automatically earn 5 percent per year,[36] but when the account has been depleted the retiree must exist solely on the annuity payments from Social Security and the defined benefit plan (if applicable) until further savings may be set aside. In the alternative case, it is assumed that all individual account wealth is paid out in the traditional manner of a defined benefit plan. This is accomplished by assuming an annuity is purchased at age 65 based on unisex mortality rates and a 5 percent discount rate.

In both cases, deficits are recorded in any year that there is insufficient retirement income to meet that year's simulated expenses and there is not a sufficient amount in the individual account balances or retiree savings to cover the difference. If additional money becomes available later in the retiree's life, the excess is recorded as a negative deficit up to the amount of the then existing cumulative deficit. Any amounts not spent from the annuity payments are also assumed to be earning 5 percent per year until they are needed to pay future expenses.

The value of net housing equity, if any, can make a significant difference in a retiree's ability to meet expenses later in life. However, there appears to be no consensus opinion on when, if ever, retirees will liquidate the equity in their house or in what form. Therefore, the model produces three different scenarios with respect to housing equity:

1. Retirees are assumed to never liquidate their housing equity.
2. Retirees are assumed to annuitize housing equity immediately at retirement (e.g., purchase a reverse annuity mortgage).
3. Retirees are assumed to liquidate the housing equity only when they needed to pay expenses and they keep the proceeds as a lump sum.

Figure 7a presents the reduction (in current dollars) for the average present value deficit for Massachusetts' single male retirees when accumulated throughout their simulated life span if all retirement wealth is paid out in the traditional manner of a defined benefit plan as opposed to the baseline situation where individual account balances are allowed to be spent when needed. In each case, the difference is largest when no liquidation of the housing equity is assumed and the values range from an average of $1,671 to $3,863. The reductions are slightly smaller when the model assumes housing equity is annuitized at retirement due to the fact that in some cases retirees who otherwise would have outlived their individual account balances and been left with insufficient monthly income will now have additional

income from the proceeds of the sale of the house. The smallest reduction takes place in the third housing equity scenario with the results ranging from $747 to $2,492.

Figure 7b provides similar figures for single females.[37] With the exception of the oldest birth cohort, nearly all of the dollar figures are larger for females than for males, largely as a result of the unisex nature of the annuity calculation. The reduction when no liquidation of the housing equity is assumed ranges from $1,869 to $3,990. There is less of a reduction (and in one case there is actually an increase) for females when the model assumes housing equity is annuitized at retirement as a result of their lower simulated net housing equity on average. Similar to single males, the smallest reduction takes place in the third housing equity scenario, with the results ranging from $799 to $2,726.

Figures 8a and 8b provide the same results as Figures 1a and 1b, however, in percentage terms instead of dollar values. Even though the dollar value of longevity risk transfer was typically larger for females, it provides a smaller percentage reduction due to the larger absolute values of deficits simulated for females. When the model assumes no liquidation of the housing equity, the percentage value ranges from 13–26 percent for males but only 6 to 14 percent for females. The smallest percentage reduction takes place in the third housing equity scenario, with the results ranging from 8–20 percent for males and 4–11 percent for females.

Conclusion

Whether the longevity risk transfer inherent in the standard type of defined benefit plan design will have value to an individual employee will obviously depend, inter alia, on their actual life span. As this will not be known in advance, this analysis measures the lifetime deficit reductions simulated to occur when all retirement plan wealth is assumed to be paid out under a defined benefit type annuity and pools the results across all members of each birth cohort. In all cases the defined benefit plan design results in a positive reduction. In percentage terms the results vary from a low of 8 percent to a high of 26 percent for single males depending on birth cohort and housing equity assumption. Similar analysis for females ranges from a low of 4 percent to a high of 14 percent.

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Endnotes

[1] Portions of this section borrow heavily from Olsen and VanDerhei (1997)

[2] Life annuities provide a payment on a periodic basis for the life of the participant and possibly his or her spouse

[3] There is often a mistaken notion that a DC plan will commit the employer to a specific contribution (typically a percentage of compensation) each year. While this is true of one type of DC plan (a money purchase plan requires the same contribution each year unless the plan is amended or terminated), employer contributions to a DC plan may be made as a percentage of profits, a percentage return on investment or equity, or as a discretionary amount decided annually. Usually DC plans allocate the contribution as a percentage of employees' earnings or savings.

[4] Flat-benefit formulas are often encountered under collectively bargained plans.

[5] Under the latter formula, an employee would receive the same benefit at retirement regardless of the number of years worked (typically subject to some minimum threshold such as 10 years). Under the former, an employee typically earns more benefits for every year of additional service.

[6] Employees' contributions to DB plans are only granted tax-favored status in public plans.

[7] Bodie (1990) develops the first four and also includes a fifth risk: Social Security cuts. The latter refers to the political risk that the financial problems currently facing the Social Security system may be resolved by cutting back on benefits currently scheduled to be paid. See Olsen, VanDerhei, and Salisbury (1997) for a more complete discussion of this issue.

[8] For an exhaustive list of plans specifically excluded from coverage by the PBGC, see pages 278-279 of Allen et al., 1997.

[9] An individual can use self-annuitization as a strategy to ensure that he or she does not outlive a particular amount of principal. This may be accomplished by dividing the account balance each year by his or her life expectancy at that point in time and limiting annual consumption to the amount determined by the calculation. This step is typically repeated each year, and the annual amount will vary from year to year depending on investment income and changing life expectancies.

[10] There may be second order impacts to consider. For example, a sponsor that has had extraordinarily favorable investment experience in recent years may be more likely to provide future benefit improvements or ad hoc cost-of living adjustments (COLAs).

[11] Note that this is not the same as guaranteeing the standard of living will not be impacted. For an interesting discussion of the possible application of this concept to retirement plans, see Merton (1983).

[12] See Clark, Allen, and Sumner (1983) for a survey of practices among private sponsors.

[13] Prior to 1980, employer pension accounting was governed by Accounting Principles Board Opinion No. 8, *Accounting for the Cost of Pension Plans*. This opinion replaced the previous discretionary method of accounting for pension costs with a possible range of minimum and maximum annual costs based on a number of approved actuarial cost methods. However, the relevance of this methodology was questioned after the enactment of the Employee Retirement Income Security Act (ERISA) in 1974. FASB therefore added two pension projects to its agenda: one for the pension plan itself (FAS 35) and one to cover accounting by plan sponsors for pension benefits. The latter project yielded an interim statement (FAS 36) in 1980 that was later replaced with FAS 87. The new accounting requirements mandated by FAS 87 were phased in over several years. The income statement provisions were to be applied for fiscal years beginning after December 15, 1986 while the balance sheet provisions were to be applied for fiscal years beginning after December 15, 1988. For additional detail on the evolution of pension accounting standards see VanDerhei (1988).

[14] A recent study by two Federal Reserve Board staff members concludes that stocks of those sponsors reporting substantial earnings from pension plans were systematically overvalued in recent years as a result of the accounting rules (Weil, 2003). The authors of the study conclude that investors tend to apply the same P/E multiples to pension earnings as they do to earnings from the sponsor's core operations.

[15] See Exhibit 2 of Levy and Young (2003) for a comparison of FRS 17, FAS 87 and the international standard, IAS 19.

[16] An immunization program attempts to construct a portfolio of bonds whose market value equals the present value for the selected set of liabilities and, even if the interest rate changes, whose value will always be at least as great as the value of the liabilities.

[17] As mentioned above, the Pension Benefit Guaranty Corporation insures promised benefits (subject to a maximum monthly limit) when a bankrupt plan sponsor is unable to pay all the promised benefits from an underfunded plan.

[18] Milliman USA (2003) reported similar results in a survey of 100 of the largest companies with the largest defined benefit plans: a funding ratio of 82 percent with 89 percent of the companies in a deficit position.

[19] However, the full-funding limit based on 170 percent of current liability is reinstated pursuant to the general sunset provision of EGTRRA for years beginning after 2010.

[20] For more detail on the process of reversions see VanDerhei (1989).

[21] Portions of this section are based on VanDerhei (1999).

[22] Although this testimony focuses exclusively on cash balance plans, hybrid arrangements that combine traditional defined benefit and defined contribution concepts include pension equity plans, age-weighted profit sharing plans, new comparability plans, floor-offset plans, new comparability profit-sharing plans and target plans (Campbell, 1996).

[23] All assumptions for this chart replicate those in Purcell (1999) with the exception of the benefit accrual rate which was decreased to 0.91 percent to allow for benefit equivalence of the two programs assuming 40 years of participation in the same program. The pay credits varied as follows: years 1-10: 4 percent, 11-20: 5.5 percent, 21-40: 7 percent.

[24] For example, age-weighted pay credits under the cash balance plans and early retirement provisions under the final-average plan.

[25] Note that they will not be exactly equal given that the pay credit differs from the assumed interest credited to the cash balance plan (5.6 percent).

[26] In addition to these retirement plan-specific reasons, there may also be overall compensation or administrative concerns that are specifically addressed through a conversion. Two of the more common reasons include supporting a total compensation philosophy in the context of a new performance-based arrangement with employees and providing a platform for merging disparate pension plans as a result of merger and acquisitions activity (Towers Perrin, 1999).

[27] Using both administrative records and worker reports of pension provisions.

[28] In the case of the job-changer, it is assumed that the full amount of any cash balance proceeds would be reinvested in a tax-deferred retirement savings account and earn an average annual rate of return of 8.65 percent, while the employee covered by a final-average plan would remain in a terminated vested status and not receive lump-sum distributions.

[29] The calculation is obviously more complicated in an integrated plan.

[30] For example, at AT&T, employees can receive a cash payment for the entire amount in their accounts if the difference between the account balance and the highest year of eligible pay is $30,000 or less. Otherwise, employees are limited to a cash payment equal to one year's worth of their highest eligible pay, with the rest paid as a monthly annuity (Burlingame and Gulotta 1998).

[31] For example, Eastman Kodak reportedly will introduce a first time match to its 401(k) plan to counterbalance losses from its conversion from a final average plan to a cash balance plan (Morrow, 1999).

[32] In addition to the potential cash flow problems arising from increased LSDs under cash balance plans, the liability durations of cash balance plans appear to be between seven to eight years as opposed to the 12- to 20-year durations typically calculated for traditional final average plans. Although the eventual impact (once the various transition provisions allow more of the liabilities to be generated via the new cash balance component) of the decreasing liability durations on the plan sponsor's asset allocation is debatable (Williamson, 1999) it would appear that the

expected rate of return on cash balance portfolios will remain significantly greater than the expected interest rate credited to the employees.

[33] See Bone (1999) for a more complete description of the calculations required under FASB Statement No. 87.

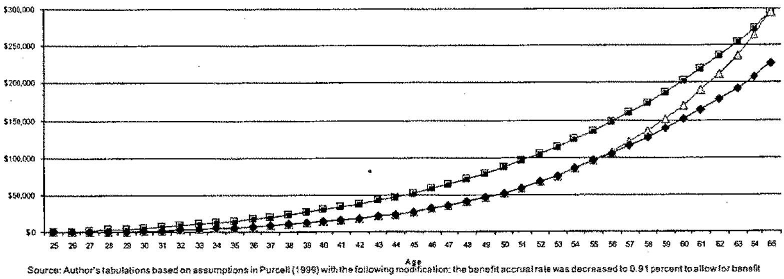
[34] As the authors point out, this is a procedure that can be utilized by plan sponsors with or without a shift to a cash balance plan.

[35] See Sher (1999, p. 22) for an illustration of how the increasing or decreasing the current 30-year Treasury bond rate by 1 percent can impact the relative comparisons between an existing traditional defined benefit plan and a new cash balance plan.

[36] Although the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project has asset allocation information on millions of individual employees, no such data exists for retirees.

[37] Similar information for married couples will be available once information is obtained with respect to utilization of joint-and-survivor options for qualified plans.

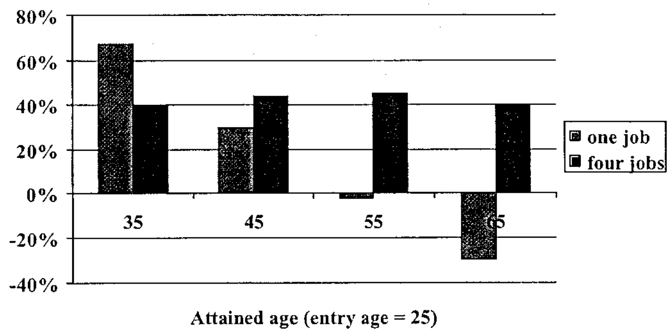
Figure 1: Illustration of a conversion from a hypothetical traditional final average defined benefit plan to a hypothetical service weighted cash balance plan (without transition credits) at age 55



Source: Author's tabulations based on assumptions in Purcell (1999) with the following modification: the benefit accrual rate was decreased to 0.91 percent to allow for benefit equivalance of the two programs assuming 40 years of participation in the same program.

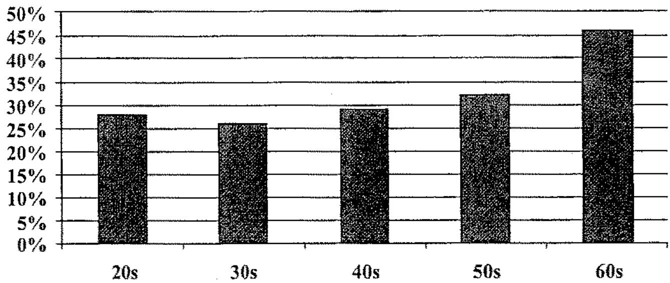
cash balance (service weighted) — traditional final average defined benefit plan — conversion at age 55 (without transition credit)

Figure 2. HYPOTHETICAL percentage increases in annual benefits at NRA Cash Balance vs Final Average Plan: impact of job tenure



Source: EBRI tabulations based on tables from Patrick Purcell, Pension Issues: Cash-Balance Plans, CRS Report for Congress, May 24, 1999

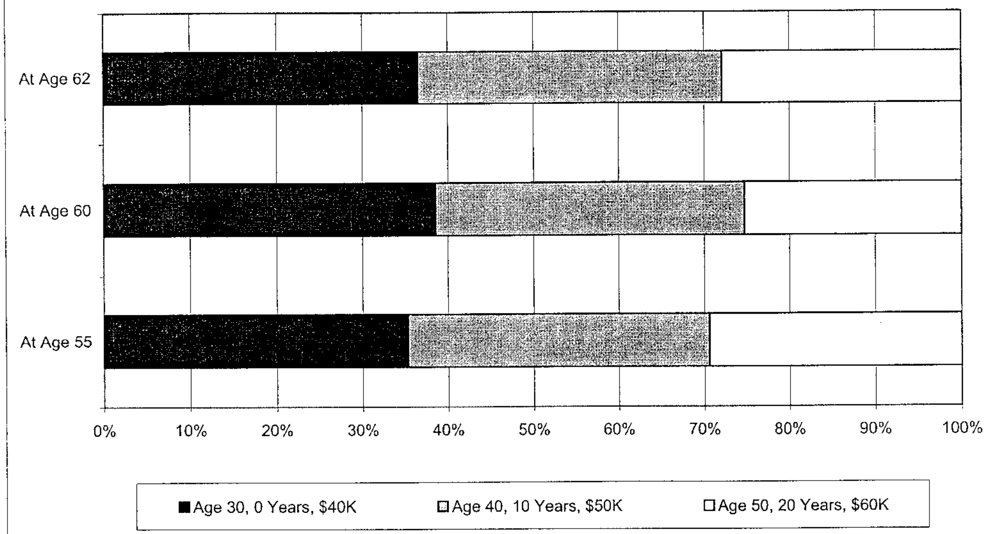
Figure 3. Percentage of 401(k) participants with zero exposure to diversified equities: 1996



N.B.: approximately 1/2 of these participants have exposure to company stock and/or balanced funds

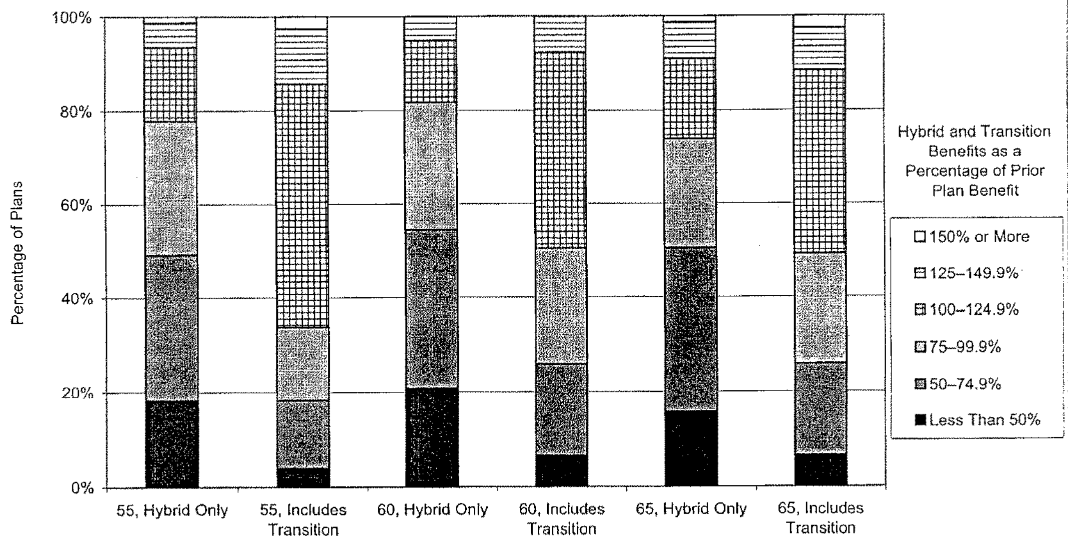
Source: *401(k) Plan Asset Allocation, Account Balances, and Loan Activity by Jack VanDerhei, Russell Galer, Carol Quick, and John Rea, Joint EBRI/ICI publication, January 1999*

Figure 4
Benefit Reductions at Age 55 Attributable to the Elimination of Early Retirement Subsidies in the Shift From Traditional Pensions to Hybrid Plans



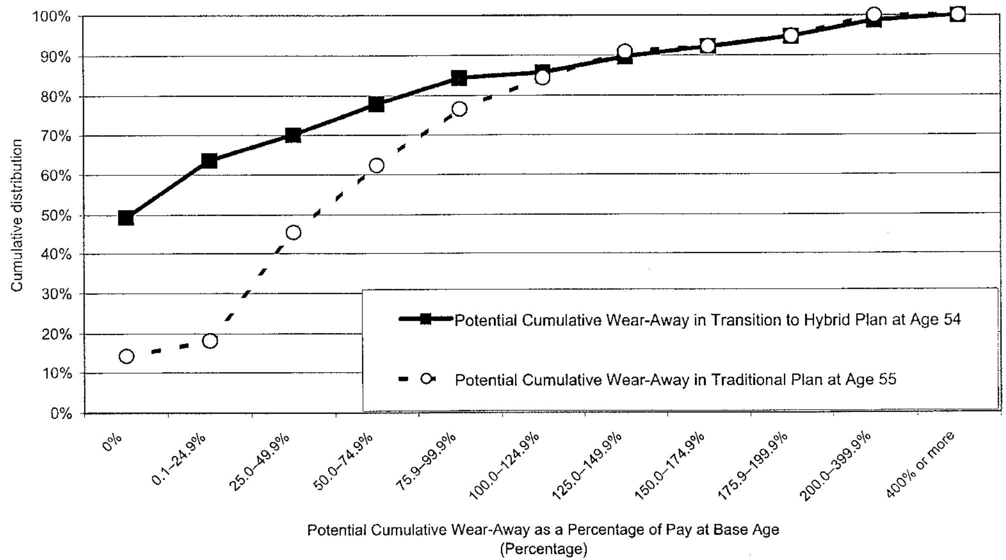
Source: Clark and Schieber (2000)

Figure 5
Benefits Under Hybrid Plans Relative to Prior Plans,
For Workers Age 50 With 25 Years of Service With Salary of $60,000 at Conversion



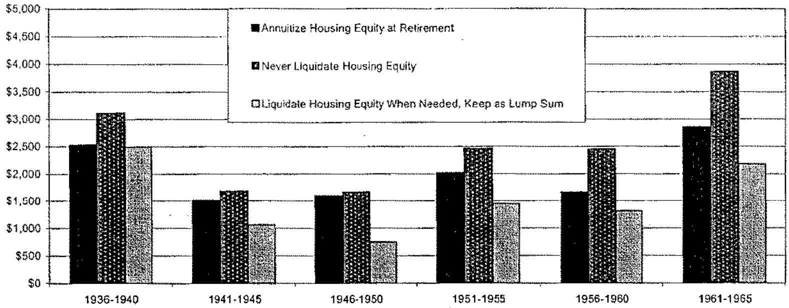
Source: Clark and Schieber (2000)

Figure 6
Potential Wear-Away for a Worker Age 54 With 25 Years Service in the Transition to a Hybrid Plan, Compared With a Comparable Worker in the Prior Plan
(Percentage of Plans)



Source: Clark and Schieber (2000).

Figure 7a
Reduction in Current Dollars for Average Utimate Present Value Deficit for Massachusetts' Single Male Retirees, If All Retirment Wealth is Paid Out in the Traditional Manner of a Defined Benefit Plan



Source: EBR-ERF Retirement Income Projection Model.

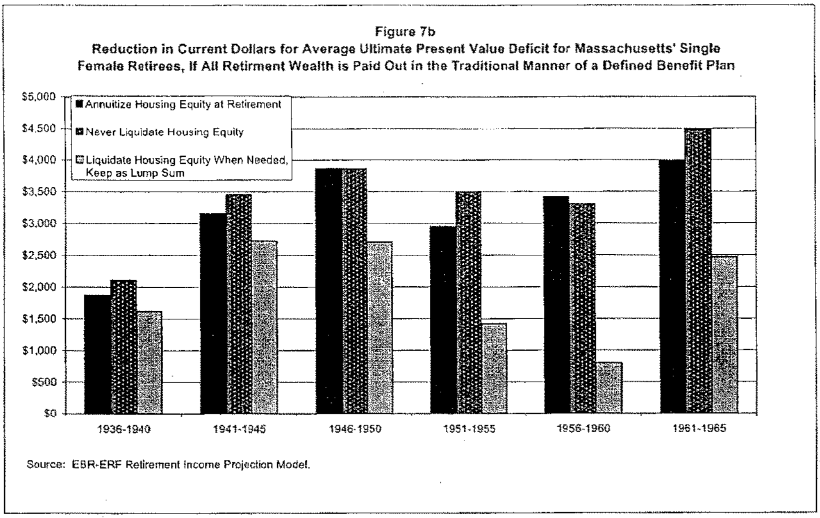
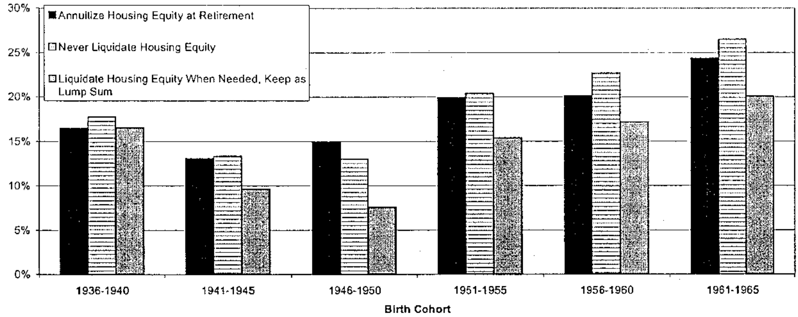


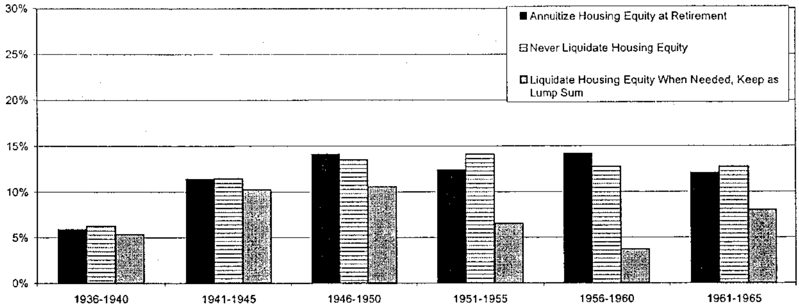
Figure 7b
Reduction in Current Dollars for Average Ultimate Present Value Deficit for Massachusetts' Single Female Retirees, If All Retirment Wealth is Paid Out in the Traditional Manner of a Defined Benefit Plan
Annuitize Housing Equity at Retirement
Never Liquidate Housing Equity
Liquidate Housing Equity When Needed, Keep as Lump Sum
$5,000
$4,500
$4,000
$3,500
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$0
1936-1940
1941-1945
1946-1950
1951-1955
1956-1960
1961-1965
Source: EBR-ERF Retirement Income Projection Model.

Figure 8a
Percentage Reduction For Average Ultimate Present Value Deficit for Massachusetts' Single Male Retirees, If All Retirment Wealth Is Paid Out in the Traditional Manner of a Ddefined Benefit Plan



Source: EBR-ERF Retirement Income Projection Model.

Figure 8b
Percentage Reduction For Average Ultimate Present Value Deficit for Massachusetts' Single Female Retirees, If All Retirement Wealth Is Paid Out In the Traditional Manner of a Defined Benefit Plan



Source: EBR-ERF Retirement Income Projection Model.

APPENDIX C – WRITTEN STATEMENT OF JOHN LEARY, ESQ., PARTNER O'DONOGHUE AND O'DONOGHUE, WASHINGTON, D.C.

TESTIMONY OF JOHN LEARY
PARTNER, O'DONOGHUE & O'DONOGHUE
WASHINGTON, D.C.

BEFORE THE SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS
COMMITTEE ON EDUCATION AND THE WORKFORCE
UNITED STATES HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.
JUNE 4, 2003

Chairman Johnson, Ranking Minority Member Andrews and Members of the Committee:

Thank you for the opportunity to appear before the Committee and present information dealing with the strength and future of defined benefit multiemployer pension plans. My name is John Leary, and I am an attorney with the law firm of O'Donoghue & O'Donoghue in Washington, D.C. My practice, as well as a large part of the practice of my firm, is in the area of employee benefits. O'Donoghue & O'Donoghue represents more than 120 employee benefit plans covered by ERISA. The majority of these plans are the product of a collective bargaining relationship between employers and labor organizations, in which contributions made by employers for work performed by employees provide the funding for the benefits provided. In addition to my legal practice, I am also an adjunct professor at the Columbus School of Law of Catholic University, where I have taught a course for the past eight years on collectively bargained employee benefit plans.

A sizable number of the employee benefit plans with which I work are multiemployer defined benefit pension plans. It is about these plans that I wish to focus my remarks, and I specifically want to direct the Committee's attention to a problem confronting a significant number of these plans in regards to their funding obligation. Left unresolved, this problem would substantially undermine the viability of these plans, threaten their continued existence and jeopardize the economic security of the current and future retirees who are their participants.

As a starting point, I'd like to identify a few characteristics of defined benefit pension plans. I speak here as a strong advocate of these plans. From the employees' perspective, they are the best type of pension plan to have. Not only do they provide the largest benefit in terms of the amount going to participants, but also they deliver that benefit in a way that enables retirees to live with a substantial measure of comfort and dignity. In a defined benefit plan, there are no individual accounts. Rather, contributions are pooled and invested with the guidance of professional investment managers, and benefits are paid to participants when they retire based on a formula set out in the plan documents. The nature of the promise made by the defined benefit plan to the participant is that, upon retirement, he or she will receive a benefit of specified value. This promise of a specific benefit that defined benefit plans make differs dramatically from the promise made by a defined contribution plan. In that case, the promise is simply that a specified sum will be contributed by the sponsor into a participant's individual account. The money from that individual account, after investment returns and losses on it (net of expenses), becomes the entitlement of the participant. Thus, in a defined contribution plan, the sponsor's obligation is limited to making the required contributions. By contrast, with a defined benefit plan, the sponsor has guaranteed to provide a specific benefit.

Another factor that makes defined benefit plans a better source of retirement income than defined contribution plans is that with the former, the participant's entitlement is generally available only upon retirement, and then only in an income stream payable over the life of the participant. By contrast, defined contribution plans generally offer opportunities whereby participants can take money from their account prior to retirement. Many defined contribution plans offer loan opportunities and/or hardship withdrawals, whereby participants who are not retired can take money from their account to meet immediate financial needs. Also, many

defined contribution plans allow participants who have not retired to take the entire amount out of their account when they have not been working in employment covered by the plan for a specific period of time. While all of these options can help participants facing adverse financial circumstances prior to retirement, they have the significant negative effect of lessening, or even eliminating, their retirement income. Further, even if a participant in a defined contribution plan has not depleted his account by the time he retires, he has the opportunity to take it as a lump sum at that point. Defined contribution plans are required to offer distribution of benefits in an annuity form, but few participants accept this option, electing instead to take a lump sum payment which these plans also provide. Many who do so use this sudden infusion to meet immediate financial needs or desires. As understandable as such a decision may be, there is no question that in so doing participants jeopardize their ability to provide for themselves and their family during retirement.

These features are not present in defined benefit plans. Participants are able to receive benefits only upon retirement, disability or death. Thus, the sums contributed into a defined benefit plan stay in the plan and realize investment earnings throughout the participant's work life. Further, once the participant does retire, the benefit will almost always be paid in an annuity form, payable over the life of the participant, or if married, over the lives of the participant and the spouse.

A final characteristic to note about defined benefit plans is that they are in decline. Simply put, fewer employers provide this form of benefit, and fewer employees are covered by them. The reasons for this decline are varied, and it is a good deal more pronounced in the realm of single employer plans than in multiemployer plans. However, the decline is palpable, and it is essential that current problems which would exacerbate this decline be addressed and remedied. This Committee is in a position to do so. As discussed in more detail below, I believe that a one-time extension of the amortization period used by plans to absorb the impact of the unusual market declines suffered over the past three years, as proposed in H.R. 1776, is an action of great benefit to the preservation and continued viability of multiemployer defined benefit plans.

I would now like to focus on such plans. Multiemployer plans are a subset within the larger universe of defined benefit plans, but a very sizable subset. The Pension Insurance Data Book 2002 produced by the Pension Benefit Guaranty Corporation ("PBGC") shows that there are more than 9.5 million participants in multiemployer plans covered by the PBGC program. The multiemployer plans share many of the same characteristics and confront many of the same problems as do single employer defined benefit plans, but there are also aspects unique to them. Perhaps the most fundamental distinction is that multiemployer plans are the product of a collective bargaining relationship entered into by a labor union and a group of employers. The union represents employees in a trade or industry, while the employers do business in that trade or industry. If the bargaining parties agree, there will be a requirement for employers to make contributions at a fixed rate into a defined benefit pension plan for their employees covered by that agreement. Depending upon the geographical scope of the bargaining agreement, the plan that results will cover a local area, a larger region or even be nationwide. Similarly, the nature of the employers participating in a multiemployer plan may vary dramatically, from a large national corporation to a small local business. What is often misunderstood, or overlooked, about multiemployer plans, is that, just as their name implies, these plans provide literally tens of

thousands of small employers with the opportunity to provide competitive, comprehensive benefits plans to their employees achievable through the combined economies of scale these plans provide, which would otherwise be too expensive and administratively complex for them to provide on their own.

The Employee Retirement Income Security Act ("ERISA") imposes substantial requirements upon these plans. The money contributed into the plan under the collective bargaining agreement is required by ERISA to be put in a trust and to be used exclusively for providing benefits to participants. The money in the trust, together with the investment income generated by that money, is the sole source for payment of benefits to participants. ERISA further requires that this trust be administered by a board of trustees made up of an equal number of individuals selected by the employer and the labor organization. Under ERISA, those trustees must act for the sole and exclusive benefit of the participants in the plan, and they cannot function in the interest of or as representatives for the party that appointed them. Those trustees will be held personally liable for any failure to meet this standard of conduct, and they are judged against the standard of the "prudent expert," under which they are required to carry out their duties as trustees as would a prudent expert confronting similar circumstances. For one to think of multiemployer plans as "union plans" or as servile appendages of the labor organization which helped to establish them is to misunderstand completely not only their legal status, but also their structure and operations.

Multiemployer plans thus have certain unique characteristics. Unlike with a single employer plan, the entity that sponsors the plan is different from the entity that provides funding for it. While a single employer that sponsors a plan has ready access to money to make additional contributions to address funding shortfalls, the board of trustees sponsoring a multiemployer plan does not, since the contribution stream is set by the bargaining agreement. Second, that bargaining agreement is almost invariably for a multi-year period, with three years being a common duration with clients I represent. The obligation to make contributions and, more importantly, the amount of those contributions is fixed in advance by the bargaining parties. Thus, the trustees, who are not bargaining parties, do not have the capacity to change the amount of contributions to come into the plan during the life of the bargaining agreement. When a funding problem arises, a multiemployer plan not only lacks a ready source of money to address this problem, but it also lacks the ability to go back to the source of funding and seek additional contributions. Understandably, employers signed to bargaining agreements which set out the contribution amount they are required to make will be opposed to increases in their obligation while the agreement is still in effect. Having bargained for a specified rate of contributions, they will want to keep to the terms of that bargain.

When compared to single employer defined benefit plans, on the whole multiemployer plans are older. Being older, or "mature" as the term is commonly used, means that the multiemployer plan has a relatively high proportion of retirees to actively working employees. Multiemployer plans typically do not derive as much a portion of their assets from employer contributions as do single employer plans. Thus, multiemployer plans are particularly reliant on investment income to maintain their fiscal health.

A final distinguishing characteristic of multiemployer plans is that, on the average, they are better maintained than are single employer plans. This point is particularly worthy of note. As the PBGC's study shows, the number of multiemployer plans has not declined nearly as dramatically as has that of single employer plans, with much of that shrinkage resulting from the merger of small plans rather than a termination of the plan. Indeed, the total number of participants in multiemployer plans has grown almost 20% since 1980. The health of multiemployer plans is further evidenced by the fact that the PBGC has had to assume minimal responsibility in providing guaranteed benefits to their participants. Since that agency's establishment by ERISA, only 31 multiemployer plans have received PBGC assistance. This record contrasts significantly with the PBGC's well known history of single-employer plan relief. As a result, the PBGC's multiemployer program has had an asset surplus every year since 1982, with last year's surplus of $158 million exceeding the annual average of $138 million over this period. The premium payment required of multiemployer plans by the PBGC—$2.60 per participant—has been and continues to be a small fraction of that required from single employer plans. It is equally noteworthy that the PBGC has not found it necessary to change this rate in over 20 years.

Yet despite the apparent health of multiemployer plans, a severe threat looms in their future. That threat arises out of ERISA's minimum funding obligation for defined benefit plans. Because, as noted above, multiemployer plans by their nature promise a specific benefit, ERISA requires that they take in a sufficient amount of money on an ongoing basis to ensure that they have money to pay the benefits. There is a complex and technical set of procedures used to determine if this requirement is satisfied. Specifically, plans are obligated to satisfy a minimum funding standard in a plan year, an objective achieved by not having an accumulated funding deficiency. A defined benefit plan will not have an accumulated funding deficiency as long as the total charges to the plan's funding standard account in a plan year are not greater than the total credits to that account in that year. In determining this funding obligation, plans adopt an interest rate which they can use to estimate how much investment return they will realize with the passage of time. Further, given the recognized volatility of investments, multiemployer plans can amortize over a fifteen-year period their investment gains and losses in each year.

If a plan incurs an accumulated funding deficiency, the consequences are dire. In the case of a multiemployer plan, the board of trustees as plan sponsor will be required to compel the contributing employers to pay into the plan the additional amounts needed to meet the minimum funding standard, bringing suit against them if necessary. These compelled contributions will, it must be understood, be in excess of those amounts employers agreed to contribute in accordance with the collective bargaining agreement. In addition, an excise tax equal to 5% of the accumulated funding deficiency will be assessed by the Internal Revenue Service, with this sum prorated against each contributing employer based on its proportion of contributions. If the plan does not cure the accumulated funding deficiency in a timely manner, then this 5% penalty can rise to 100%. Further, the amounts paid by employers in these penalties are not deductible for tax purposes, in contrast to the standard employer contributions to the plan.

With a single employer plan, it is possible to see that the employer in his capacity as plan sponsor and often as plan administrator should bear the responsibility for an accumulated funding deficiency, as it is the norm rather than the exception that single employer plans

contribute only the amounts needed to meet their minimum funding obligation and, in years such as we experienced during the 1990s, when the investment returns produce sufficient income to meet that minimum, no contributions may be made. It is readily apparent, however, that with a multiemployer plan, these sanctions fall on a wholly innocent party. Indeed, with a multiemployer plan, there is not a guilty party to be found. Employers who contribute to multiemployer plans recognize that the multi-year nature of their contributions requires stability in their contributions. That has meant that plans be funded more conservatively, above the minimum, with investment gains flowing through to the participants in the form of benefit increases. The contributing employer to a multiemployer plan, therefore, has come to expect that he has met all of his contractual obligations as long as he has made the contributions required by the collective bargaining agreement. Nevertheless, he is still going to have to pay the price, by way of increased contributions and penalties, if a deficiency occurs.

These minimum funding requirements have been in place since the passage of ERISA, clearly enacted with the laudable intent of making sure that plans can pay promised benefits. However, it is only recently that these sanctions have moved from the abstract to the all too possible, from being assessed against that small fringe of poorly managed plans to possibly being applied to even the best run of multiemployer plans. The sole reason for this is the equity investment results these plans have experienced for the last three years. For the first time in more than 60 years, there have been three consecutive years of negative investment return. Since most of these plans are less than 60 years old, it can truly be said that their investment experience over the past three years has been unprecedented. The result has been that the typical multiemployer plan, which for funding purposes may assume an annual investment return of 7% to 7.5 %, might instead have had three straight years of losing 7% to 7.5%. At the end of three years, the plan is, in terms of funding, more than 40% below where it expected to be. Prior to the equity downturn, multiemployer plan actuaries would calculate that the plan would not incur an accumulated funding deficiency over the next 30-year period. With those same actuaries looking at those same plans now, an accumulated funding deficiency may be on course to strike in less than a decade. Thus, an accumulated funding deficiency, a previously unimaginable occurrence, has become a foreseeable future outcome.

It is safe to say that virtually every multiemployer plan has been adversely affected by the performance of the equity markets. While the typical multiemployer asset allocations has an equity commitment of 50% to 55%, a proportion certainly lower than that of most single employer plans, these plans put a significant amount of their assets into stocks. A major reason for this is the generally held position of investment experts that, on a long-term basis, equities provide the surest and greatest rate of return. Further, the fiduciary requirements of ERISA compel trustees to diversify plan assets. While it would be imprudent to invest solely in equities, it would be even more imprudent for a plan to eschew equity investment entirely. Also, this dramatic decline manifested itself in all sectors of the equity market. A plan could not have avoided it by targeting certain types of equity investments which continued to thrive. There were no such ports in this storm. Further, this decline could not be offset by equivalent gains in other investment sectors, such as bonds, cash equivalent vehicles or real estate. The plans' investment in these other sectors alleviated the amount of their loss, but it certainly did not provide a basis for full recovery.

The minimum funding crisis can thus be understood as almost exclusively the product of the investment climate of the past three years. It would be a gross misperception to view funding problems as resulting from multiemployer plans improvidently increasing benefits to curry favor with participants at a time when there were insufficient assets in the plan to provide for these benefits. In actuality, to the extent plans increased benefits in the years that recently preceded 1999, this decision was generally caused by the fact that plans were compelled to do by the maximum funding limitations of the Internal Revenue Code. These provisions disallow an employer's deduction of contributions to a plan if they exceed a maximum funding limitation. As discussed above, the contributions to a multiemployer plan are fixed by a bargaining agreement. Plans were thus not in a position to curtail that contribution stream, and an increase of benefits was the only course of action available to plans that needed to make sure that employer contributions remained deductible. It is thus an egregious error to see these plans as being largely responsible for the funding dilemma they now confront.

When plans look to their future as they are required to do to ensure that funding obligations are meet, it is a common experience to find that an accumulated funding deficiency looms at some point ahead. It is impossible to say with certainty how many plans will have a deficiency and when it will occur, but it is estimated that at least one-third and quite possibly more than 50% of multiemployer plans will confront this problem within the next several years. What can be said with certainty is that it will strike a large number of plans, and that its impact will be extremely deleterious to those plans, their contributing employers and their participants.

Yet plans will incur an equally harmful impact even before an accumulated funding deficiency occurs. In an effort to forestall either an accumulated funding deficiency or one's individual liability for it, courses of action will be followed which will undermine the health of these plans. From the trustees' perspective, they will see that more money must come into the plan, which means increasing employer contributions. Employers will understandably be reluctant to do this, at least while a multi-year bargaining agreement remains in effect. Even when the agreement expires and the union is in a position to seek additional contributions through the bargaining process, this will be difficult, especially when one keeps in mind the fact that funding of health funds is also often a part of these same bargaining agreements, and that an increase in contributions into a pension fund may often have the ancillary effect of less money going into an already financially strapped health fund. Moreover, even if a plan succeeds in increasing the contribution amount, it may not help. The benefit formulas used by many multiemployer plans tie the benefit amounts earned by a participant to the amount of contributions made by employers on his behalf. For plans with these percentage-of-contribution formulas in place, an increase in contributions causes a parallel increase in benefit accruals, without providing any amelioration of the funding shortfall.

Besides employer contributions, the other source of revenue for defined benefit plans is investment income. As noted above, multiemployer plans have historically been conservatively invested, with their trustees ever mindful of the long-term health of the plan. As these plans confront an immediate need for additional revenue to satisfy the minimum funding obligation, it is not unimaginable to think of plans taking more investment risks out of an understandable but ill-advised desire for quick gains. They may see such behavior as the only way to avoid the

disastrous impact of an accumulated funding deficiency. In so doing, they jeopardize the continued viability of the plan.

If plans cannot sufficiently increase their revenue, their only other option is to reduce their expenditures. Other than administrative expenses, the only expenditures these plans have is the payment of benefits. Facing an imminent funding shortfall, plans will thus be compelled to reduce benefits. Indeed, several funds, including some of the nation's largest multiemployer plans, have already adopted benefit reductions as a first step towards addressing the minimum funding problem. Such reductions likely will entail not merely reducing the rate at which future benefits are accrued, but may also involve cutting benefits that have already been accrued and even benefits currently being paid to retirees. Moreover, these reductions will not only be harsh, but they also will be abrupt. With an accumulated funding deficiency swiftly approaching, plans will need to implement these cuts quickly so that their maximum financial impact can be realized. When it comes to reducing and eliminating benefits to forestall a funding shortfall, time is money. The impact that such cuts will have on active participants and on retirees can readily be imagined.

Yet by far the most harmful effect that the approach of an accumulated funding deficiency will have is on the conduct of the contributing employers. It does not take a visionary to see that onset of the deficiency is a terrible disincentive for employers to remain in the plan. It is not just that additional contributions may be sought from those employers in future bargaining agreement. Far more basically, this impending funding problem has raised the awareness of those employers, whether large corporations or small businessmen, who previously may not have known that they will be the entities required to pay the additional amounts needed to meet the minimum funding obligation. Moreover, those same employers will be assessed the 5% penalty resulting from the accumulated funding deficiency. They will owe this money even though they made all the contributions to the plan required under the bargaining agreement.

Faced with such an ominous future, it is wholly understandable that employers might decide not to continue their association with the plan. The danger of such a huge assessment being made against them could cause them to conclude that the business advantages they derive from the collective bargaining agreement are no longer worth the exposure. It is certainly foreseeable that employers would not renew their existing bargaining agreement or, in the alternative, refuse to enter into a new agreement if it contained a provision for contributions into the defined benefit plan. More regrettable still is the fact that this decision would not be limited to employers who contribute to the minority of plans that will have a funding deficiency, but would conceivably encourage employers in other industries who do not fully understand the issue to leave their plans as well.

Once employers start to leave the plan to escape an accumulated funding deficiency, increased pressure falls on the remaining employers. First of all, the withdrawal of employers means less coming in by way of contributions. Secondly, as the number of employers diminishes and the plan shrinks in size, the savings realized by economies of scale diminish commensurately. Third, the remaining employers will be forced to bear a greater share of the liability that will arise with a funding shortfall. Consequently, their ability to stay in business is threatened. Finally, employer flight of the sort likely to occur will foster a climate in which it

will be very difficult to attract new contributing employers. Becoming a contributing employer to a plan that may soon experience a minimum funding deficiency resulting in massive assessments against the contributing employers is unlikely to be seen as a prudent business decision. Multiemployer plans would almost certainly see a rush of employers to the exit at the same time that no new employers are coming through the entrance.

Notwithstanding this grim forecast, it is possible for positive steps to be taken, and this Committee is in a position to do so. One such positive step is found in the Pension Preservation and Savings Expansion Act of 2003 recently introduced for consideration. Section 708 of that bill would give multiemployer plans the option of taking an extended period of time to amortize their investment losses incurred during the period between plan years commencing July 1, 1999 and plan years ending December 31, 2003. Instead of the 15-year amortization period provided multiemployer plans by the Internal Revenue Code, they would have 30 years over which those losses could be spread. The result would be that plans and the bargaining parties who sponsor them would have a significantly longer time horizon to address the serious funding issues arising out of the unprecedented underperformance of the equities market. Multiemployer plans would be able to do so without the looming threat of an accumulated funding deficiency, with all of its negative consequences described previously.

It is important to understand what Section 708 does not do. First of all, it does not require plans to use the 30-year period to amortize their investment experience for the 7/1/99-12/31/03 period. Rather, it merely gives plans the option to do so. If a multiemployer plan is of sufficient economic health that an accumulated funding deficiency does not appear in its future, the plan could opt to continue with using the 15-year amortization schedule. Indeed, for a financially strong plan, that might well be the most prudent decision to make. Second, Section 708 can in no way be seen as an economic bailout of poorly managed plans by the federal government. As discussed above, multiemployer plans are on the whole quite well managed and quite prudently invested. The approaching crisis is not the result of reckless investment practices or irresponsible benefit improvements. Even more basically, Section 708 does not require any expenditure of federal funds. Not only would there be no infusion of capital into these plans from the federal treasury, but, by preventing serious harm to multiemployer plans, the need for significant distributions from the PBGC's multiemployer program would be forestalled. By enacting this provision, Congress would be giving plans not money but time, time to address funding issues in a deliberative and prudent manner, and time to enable plans to benefit from a revived investment climate. In this respect, Section 708 is fully in keeping with the purpose and design of ERISA as it pertains to multiemployer plans: the bargaining parties remain responsible for the agreement that provides funding of the plan, the board of trustees is responsible for the administration of the plan and the federal government maintains the regulatory framework designed to ensure the health of the plans.

Perhaps most importantly, the enactment of Section 708 would not jeopardize the funding of plans. First of all, as noted previously, multiemployer plans tend to be larger than single employer plans. They have significant amounts of assets, and are well positioned to pay benefits to their current and future retirees. While many of them could experience an accumulated funding deficiency in the future, this result is due not to any underlying weaknesses of the plans, but rather to the technical requirements of the funding rules. Section 708 is not bailing out

congenitally sick plans, but rather giving time to fundamentally healthy plans to recover from an illness by no means due to their own behavior. Second, Section 708 does not entail a change in how a plan's minimum funding standard is determined. It does not even enact a permanent change in the duration of the amortization period. Rather, it gives a one-time opportunity for plans that have gone through an unprecedented economic downturn to absorb this loss over a longer time period. In so doing, it helps preserve the viability of these plans and their ability to deliver benefits to their participants. If it is not enacted, and the current 15-year amortization period remains in effect, then the sad and ironic result would likely be the swift erosion of the multiemployer plan system that the funding rules in general and the amortization schedule in particular were designed to protect.

It is appropriate for the Committee to consider how multiemployer plans would react if the relief offered by Section 708 were to be granted. Based on the history of prudent investment and sound management that these plans have exhibited, I think that it is safe to say that they will not respond by blithely concluding that the funding problem has been resolved. Similarly, they will not deem the extension of the amortization period as a green light to grant profligate benefit improvements. Rather, I am confident that funding issues will remain in the forefront of the consciousness of the trustees of these plans, and they will use the extension as an opportunity to address these issues in a well though out manner. Thus, multiemployer plans will almost certainly reexamine their investment policies, to see what steps can be taken to maximize investment return in a prudent manner and to prevent a recurrence of the severe losses recently experienced. Plans will also scrutinize their contribution source, and see how this can be enhanced, such as by bringing in additional contributing employers, by incrementally raising the contribution amounts from current employers and by increasing the proportion of actively working participants relative to retirees. Multiemployer plans will explore making changes in the design of the plan so as to cause the funding standard account to grow. For example, if a plan calculated benefits by means of a percentage-of-contributions formula, it could be amended to provide that a portion of future contributions would not be applied to the individual participant's accrual, but rather go to the general corpus of the plan.

Part of this analysis that multiemployer plans will carry out will necessarily be of the plan's benefit structure, and whether reductions in benefits are appropriate. With the additional time provided by Section 708, the plan would have the ability to implement such reductions in a non-Draconian manner, with the adverse impact not falling suddenly and disproportionately on those least able to bear it. Rather, any reduction deemed necessary could be put into effect only after participants have been prepared for the need for these steps and have realized that a common sacrifice is essential to preserve the viability of the plan.

In addition to these active measures that can be pursued as a result of the extended amortization period, plans can also be expected to benefit by an improvement in the investment climate. It must be remembered that in the years prior to 1999, plans experienced several years of investment return significantly in excess of their actuarially assumed rate, due primarily to the equities market. As noted previously, those returns were so substantial that many multiemployer were compelled to increase benefits to avoid violating the maximum funding limitation and thereby causing employers to lose the right to deduct their contributions for tax purposes. It is not hard to imagine that this investment experience could recur in the future.

The primary catalyst for the enactment of ERISA was the failure of pension plans to have sufficient assets to pay promised benefits. Section 2 of that statute, which sets out the Congressional policy for its enactment, speaks eloquently of that loss of benefits, and of the necessity "that minimum standards be provided assuring the equitable character of such plans and their financial soundness." Section 708 is not merely consistent with this goal; it is a crucial means to achieve this goal. Its enactment will not solve the funding problems of multiemployer plans. However, it will give those plans time to solve those problems themselves, and their record over the years should give this Committee confidence that they have both the will and the ability to do so.

Thank you again for the opportunity to appear before this Committee.

Committee on Education and the Workforce

Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)

Your Name: **John Leary**		
1. Will you be representing a federal, State, or local government entity? (If the answer is yes please contact the Committee).	Yes	No **X**
2. Please list any federal grants or contracts (including subgrants or subcontracts) which you have received since October 1, 1998: **None**		
3. Will you be representing an entity other than a government entity?	Yes	No **X**
4. Other than yourself, please list what entity or entities you will be representing: **None**		
5. Please list any offices or elected positions held and/or briefly describe your representational capacity with each of the entities you listed in response to question 4: **None**		
6. Please list any federal grants or contracts (including subgrants or subcontracts) received by the entities you listed in response to question 4 since October 1, 1998, including the source and amount of each grant or contract: **None**		
7. Are there parent organizations, subsidiaries, or partnerships to the entities you disclosed in response to question number 4 that you will not be representing? If so, please list:	Yes	No **X**

Signature: John Leary Date: **June 2, 2003**

Please attach this sheet to your written testimony.

PERSONAL INFORMATION: Please provide the committee with a copy of your resume (or a curriculum vitae). If none is available, please answer the following questions:

a. Please list any employment, occupation, or work related experiences, and education or training which relate to your qualifications to testify on or knowledge of the subject matter of the hearing:

Resume attached.

b. Please provide any other information you wish to convey to the Committee which might aid the members of the Committee to understand better the context of your testimony:

As an attorney in private practice, my work focuses on collectively bargained employee benefit plans. Multiemployer defined benefit pension plans constitute a substantial portion of that practice.

Please attach to your written testimony.

JOHN LEARY
9904 Thornwood Road
Kensington, Maryland 20895
(301) 530-6573

NATURE OF LEGAL PRACTICE

My legal career focuses on collectively bargained employee benefit plans, representing such plans in all matters related to the requirements of the Employee Retirement Income Security Act and the Internal Revenue Code. A substantial portion of this work involves legal issues pertaining to multiemployer defined benefit pension plans.

LEGAL EXPERIENCE

Partner - O'Donoghue & O'Donoghue, Washington, D.C. - January, 1995 – Present

Adjunct Professor – Columbus School of Law, Catholic University of America – August, 1994 – Present

Associate - O'Donoghue & O'Donoghue, Washington, D.C. - April, 1988 - December, 1994

Staff Attorney - Division of Advice, National Labor Relations Board, Washington, D.C. - August, 1987 - April, 1988

Clerk - Katz & Ranzman, Washington, D.C. - February, 1987 - May, 1987

Clerk - O'Donoghue & O'Donoghue, Washington, D.C. - May, 1986 - February, 1987

Arbitrator - Better Business Bureau, Washington, D.C. - August, 1986 - June, 1987

Clerk - Special Prosecutions Section, United States Attorney's Office, Washington, D.C. - February, 1986 - May, 1986

EDUCATION

J.D. - Columbus School of Law, Catholic University of America - May, 1987
Standing: Top 9% of class
Second Prize: John Fanning Intraschool Labor Law Writing Competition - 1987
Second Place: Robert F. Wagner Labor Law Moot Court Competition - 1986
First Place and Best Oralist: Wagner Labor Law Intraschool Moot Court Competition - 1985
Best Brief: Basic Legal Techniques Section - 1985
Moot Court Association - 1986-1987

Ph.D. - American Studies, University of Maryland - December, 1981
G.P.A.: 3.75
Phi Kappa Phi Honor Society

APPENDIX D – WRITTEN STATEMENT OF RON GEBHARDTSBAUER, SENIOR PENSION FELLOW, AMERICAN ACADEMY OF ACTUARIES, WASHINGTON, D.C.

AMERICAN ACADEMY *of* ACTUARIES

Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
U.S. House of Representatives

Hearing on:

Strengthening Pension Security: Examining the Health and Future of Defined Benefit Pension Plans

Testimony Presented By:

Ron Gebhardtsbauer, FSA, MAAA
Senior Pension Fellow
American Academy of Actuaries

June 4, 2003 at 2 pm
2175 Rayburn House Office Building

The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear, objective analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance.

Chairman Johnson, Ranking Member Andrews, and distinguished committee members, thank you for inviting me to testify on "Strengthening Pension Security: Examining the Health and Future of Defined Benefit Pension Plans." My name is Ron Gebhardtsbauer, and I am the Senior Pension Fellow at the American Academy of Actuaries. The Academy is the public policy organization for actuaries of all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis.

My written statement will focus on the three important issues for this hearing, namely:

- The advantages of pension plans, both defined benefit (DB) and defined contribution (DC);
- Reasons why complex, contradictory, and out-of-date laws hurt employer-sponsored plans and reduce the number of workers covered by DB plans; and
- Suggestions to strengthen the voluntary pension system and retirement security of all Americans and level the playing field between DB and DC plans.

Advantages of DB and DC Pension Plans

Pension plans have advantages for employers, employees, and the nation.

- **Employers** provide pension plans not only for altruistic reasons; they have sound business reasons to provide them. For example, they help employers maintain their workforce. In addition, employers contribute to pension plans because they are tax efficient ($1,000 contributed to a pension plan will provide a larger pension than $1,000 saved outside the pension plan), and because they can satisfy employee demands.

- **Employees** want an employer pension plan because it improves their chance for a secure retirement. In fact, according to public opinion research, including the Academy's, Americans most preferred saving through employers over doing it themselves or through the government.

- **Nation:** Pension plans are good for the nation, because they provide a large source of efficiently invested assets in our economy and reduce poverty among older Americans. Private pension plans are a necessary complement to government programs like Social Security.

DB plans have their own distinct advantages and disadvantages. Some people prefer DB plans, some prefer DC plans, and many like both. For example, while younger employees understand and value the cash nature of DC plans, many older employees and retirees appreciate that cash does not guarantee retirement security, as does a stable lifetime pension. In addition, when the stock market was performing well in the 1990s, many workers preferred DC plans. Now that the stock market has fallen dramatically, many workers are asking someone else to handle their savings and would prefer

employers to take care of this concern. Thus, there are advantages to having both types of plans, and many large employers do just that - they have a DB plan and a 401(k). Some special advantages of DB plans are:

- **For employees**, DB plans provide a secure, stable income for life (while DC plans do not have to provide lifetime incomes). Employees won't have to worry about risks, such as a bear market when they want to retire or after they retire, or outliving their money.

- **For employers**, DB plans can provide contribution flexibility and are better at keeping a stable workforce (e.g., employees with DC plans are more likely to retire early when the stock market does well). They are also professionally managed and achieve similar or higher returns with less risk than a typical employee-directed account (per Table E24 of the 1998 DOL Form 5500 abstract).

- **For the nation**, DB plans help reduce our dependence on social programs, such as Social Security, Medicare, Medicaid, and SSI (Supplemental Security Income) and reduce poverty rates at older ages more effectively than defined contribution plans.[1]

Problems with Pension Laws and Regulations

With all these advantages of pension plans, one would think that government policy would encourage employers to have pension plans, and be neutral (at the very least) if an employer wanted a DB plan. In the past that was true. However, gradually through time, pension rules have become incredibly complex, costly, contradictory, and out-of-date, and have come to favor DC plans. This has caused a movement to DC plans and benefits payable in a lump sum, which means that fewer people will have pensions payable for the rest of their lives. This is a concern for public policy, since that can mean increased poverty levels at older ages.

We suggest this is the primary reason for the decline in DB plans. In 1975, just after ERISA was signed into law, 40 percent of the labor force participated in a DB plan, and 16 percent participated in a DC plan (see Chart I). Today, however, the reverse is true: only 21percent participate in a DB plan, while 46 percent participate in a DC plan.[2] As Chart I shows, almost anyone who participates in a pension plan is in a DC plan. Sometimes it is in addition to a DB plan.

Analysts have attributed the movement from DB to DC plans to: (1) larger DC plan benefits for young, mobile employees; (2) employers attracting young employees with larger DC benefits upfront; and (3) DB benefits being more difficult to understand than DC benefits.

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[1] Additional advantages can be found at http://www.actuary.org/pdf/pension/testimony_20june02.pdf

[2] The 2000 Form 5500 data are not available yet, because pension plans file about 9 months after the end of the plan year, which could be September 2002 for plans with plan years starting in December of 2000.

But I do not think that they have pinpointed the reason correctly, because a DB plan can look exactly like a DC plan to the participants. If the employer and employees wanted a DC plan, with employees being able to allocate their funds, they could simply change the DB plan formula to match the DC plan they wanted. There are plans in the U.S. that already do this. This approach would be much easier than having to terminate the DB plan and start up a DC plan from scratch. In addition, with the DB plan, the employer would keep the design, investment, and contribution flexibility. So, there must be another reason.

I suggest that the biggest reason for the decline in DB plans is that the playing field is not level for DB plans in the private sector. DC plans can have certain provisions, like pre-tax employee contributions and matches that private sector DB plans cannot have. As evidence, I note that Canadian employers and state and local governments in the U.S. have a much more level playing field for DB plans (for example, they have pre-tax contributions), and all three have a much higher percentage of DB plans than in the U.S. private sector.[3]

The other primary reason is that pension laws and regulations for private sector employers in the U.S. are much more costly and onerous for DB plans (than DC plans). In fact, some pension professionals consider the regulations draconian. A study by the American Academy of Actuaries in 1993[4] showed that increased government regulation was the major factor in 44 percent of DB plan terminations in the late 1980s.

As further evidence, I note that there has also been a very large decline in DC plans that do not have a 401(k) arrangement. DOL Form 5500 abstracts show that of the 46 percent of the labor force participating in DC plans; 3/4ths of that number are in 401(k) arrangements. When you subtract out the 401(k) arrangements, you find that the remaining DC plans trail behind even DB plans. In fact, due to EGTRRA raising the contribution limits for 401(k)s,[5] the 12 percent participating in "other DC plans" may practically disappear, because money purchase plans no longer have the advantage of larger deductible contributions. In fact, the competition is not between DB and DC plans. It is between 401(k) arrangements and all other plans, and 401(k)s are far ahead.

Examples of the complex, contradictory, and out-of-date rules are:

(1) **Complex, Costly Rules:** One measure of complexity is the amount of administrative costs. The costs of administering a DC plan have doubled as a percentage of payroll since 1981 and tripled for DB plans (based on a study by the Hay Group).[6] In addition, the study suggested that pension rules made DB plans more expensive to

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[3] See Professor Rob Brown's paper discussing why a decline in DB plans did not happen in Canada in the July 2001 issue of the North American Actuarial Journal (NAAJ), and discussions in the April 2002 NAAJ.
[4] *The Impact of Government Regulation on Defined Benefit Pension Plan Terminations*, a Special Report by the American Academy of Actuaries (March 1993).
[5] EGTRRA, the Economic Growth, Tax Relief and Reconciliation Act of 2001.
[6] *Retirement Income Plan Administrative Expenses 1981 through 1996*, presented to the Pension Research Council (May 1996)

administer than DC plans.[7] It did not use to be that way. In 1981 the administrative costs of a 10,000-person DB plan were less than the costs of a similar-sized DC plan, but by 1996 the DB costs had grown dramatically to almost 50 percent more than the DC plan's administrative costs. At a company where both the employer and employees want a DB plan, costly pension laws and regulations strongly push employers to have a DC plan, so employers can end up not having what is best for their company.

(2) **Contradictory Rules:** There are many contradictory rules, caused by legitimate, competing interests. A few examples follow:

(a) **Conflicts between the various discrimination rules:** Age discrimination rules can conflict with the rules prohibiting pension plans from favoring higher-paid and longer-service workers (because the older employees are generally the higher-paid and longer-service employees who cannot be favored).

(b) **Conflicts between interpretation of lump sum rules and age discrimination rules:** An employer might want to improve interest credits in a cash balance plan for their employees, but some people interpret lump sum rules to say that the plan must pay a lump sum that would violate age discrimination rules. That interpretation keeps some plan sponsors from providing favorable investment returns to employees.

(c) **Conflicts between adequate funding and the need for government revenue (and the reversion excise tax):** Pension funding rules should allow some flexibility between the minimum and maximum contribution. However, sometimes the minimum funding rules require larger contributions than the maximum deductible rules. Fortunately, the minimum is always deductible, but it doesn't allow any flexibility. This points out the tension between revenue loss and benefit security. In addition, the maximum deductible rules inhibit contributions when a company is healthy and able to contribute more, and the minimum funding rules can force unusually large contributions at the most difficult times (e.g., today). In addition, rules taxing reversions at 50 percent (in addition to the 35 percent income tax rate) discourage employers from creating surpluses in their plans, which would increase benefit security

(3) **Out-of-date Rules:** Static pension rules have not kept up with the dramatic changes in the economy and new designs in pension plans. Some problems with out-of-date rules are:

(a) **Rules have not kept up with changes in economy:** The economy has changed dramatically over the past 5 years. Treasury rates fell much faster

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[7] For example, in the 1970s one valuation was needed every 3 years. Today, multiple valuations are needed each year for funding, PBGC disclosure, PBGC premiums, SFAS 87 purposes, etc.

than corporate bond rates. In 2000 and 2001, a pension plan that could buy annuities for all employees was labeled "underfunded" because the highest permissible discount rate was lower than interest rates used in pricing annuities. Funding rules, based on Treasury rates, dramatically increase minimum pension contributions, at a time when companies can least afford it. Fortunately, Congress fixed the rule for 2002 and 2003, but is having a difficult time deciding upon a permanent fix in a timely way for 2004 and thereafter.

(b) **Rules have not kept up with new types of plans:** New types of DB pension plans, which address the concerns of mobile employees, have been in use for over 15 years, but there are few laws or regulations addressing them. For example, see the problems discussed in our issue brief on whipsaw.[8]

(4) **Level Playing Field For DB Plans Lost:** DC plans are easier to understand, which may be why the rules for DC plans are more up-to-date than for DB plans. In particular, Congress created simple DC plans (Simple plans, 401(k)s, etc.) where the regulatory burden is greatly reduced. Unfortunately, this provides an inherent advantage for DC plans. Even if employers and employees want to have a DB plan, pension rules make that a difficult decision to make. In addition, private-sector DB plans can not have certain provisions that DC plans can have, which also discourages employers from having DB plans. Examples of these provisions are:

(a) **Pre-Tax Employee Contributions**, which governmental DB and private-sector DC plans can have),

(b) **Employer Matches of Employee Contributions:** Which 401(k)s and non-profit DB plans can have,

(c) **Phased Retirement**, which allows employees to partially retire, continue working part-time, and receive a partial pension (with early retirement subsidies, if any). DC plans can commence these pensions before the Normal Retirement Date, but not DB plans.

Fixing Pension Laws

The above problems make it difficult for employers to start up and maintain pension plans. As one can see from the above examples, pension laws in their totality need to be reviewed to create a comprehensive, sensible pension policy. The complex, contradictory, and out-of-date laws need to be fixed. In addition, laws governing DB plans need a level playing field to survive as attractive retirement programs.

In the following paragraphs, we provide some possible suggestions for resolving the complex, contradictory, and out-of-date rules discussed earlier.

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[8] "What's Whipsaw? Why is it a Problem?" at http://www.actuary.org/pdf/pension/whipsaw_feb03.pdf

(1) Fix the discount rate for funding liabilities. The most urgent need is to fix the discount rate, which is currently based on 30-year Treasury rates. As noted earlier, current funding rules have dramatically increased minimum pension contributions at a time when employers can least afford them. Part of the problem is due to the discontinuance of the 30-year Treasury bond, and the unusually low rate for determining liabilities. The chart of discount rates at the end of this testimony shows that the maximum permissible rate was less than an annuity pricing rate in 2000 and 2001, and the rate would have been lower in 2002, if it were not for the temporary fix that Congress passed last year.

Employer and labor groups have both suggested using a high-quality corporate bond rate. Pension liabilities for financial statements are generally discounted using current high-quality corporate bond rates, due to the requirements of Financial Accounting Standard 87 (FAS 87 paragraph 44) and statements by the Securities and Exchange Commission (SEC). Two bills have been proposed that would use this rate, one of which would reduce the top of the permissible range from 105 percent down to 100 percent. The Treasury Department has also suggested using a high-quality corporate bond rate, so the various parties are not far apart.

However, Treasury also suggested that the corporate discount rate be a yield curve (instead of the average long term rate) to reflect the duration of a pension plan's liabilities. This has delayed the enactment of a permanent fix. Since a yield curve has a relatively small effect on liabilities – a study shows that liabilities would only be increased by 2 to 3 percent on average – the additional complexity is not warranted. In addition, best actuarial practices would call for using more precise, individually reasonable mortality tables if we are using more precise interest measurements. Ironically, using these mortality tables would in may cases completely offset the effects of the yield curve, since the types of plans that would experience the highest increase when introducing a yield curve would generally by the types of plan that would experience the largest decreases if we were permitted to use individually reasonable mortality tables. The use of a yield curve would be expensive to implement for small plans, and would complicate other areas of pension law which are logically tied this rate (e.g., lump sum determinations, returns on employee contributions, cash balance interest credits). Thus, Congress might want to delay the requirement to use a yield curve until it has been thoroughly discussed by all parties, preferably in connection with a complete overhaul and simplification of the funding rules.

Additional details on fixing the discount rate and strengthening the funding rules for underfunded plans can be found in our paper on this subject, entitled "Alternatives to the 30-year Treasury rate."[9] Another issue that policymakers need to consider whenever the funding rules are modified is the effect of the changes on the PBGC. Increasing the discount rate in accordance with Congress's earlier intentions (something close to a corporate bond rate or annuity pricing rate) may help the PBGC indirectly if it means that employers are more likely to be able to afford their pension plans for a few more years (hopefully, until the economy recovers). This could mean that fewer plans will need to

[9] It can be found at our website at http://www.actuary.org/pdf/pension/rate_17july02.pdf.

be trusteed by the PBGC and more defined benefit plans will be around to pay premiums to the PBGC. By fixing the discount rate, Congress signals to employers its intention to keep defined benefit plans as a viable option for employer retirement programs. However, that statement comes with a caveat. Since increasing the interest rate reduces minimum contributions, we need to review the funding and premium rules, particularly if PBGC has further major losses over the next couple of years in this current economic downturn.[10]

(2) Overhaul the funding rules for DB plans. The current funding rules are incredibly complex and need to be overhauled, and for this purpose we created a task force to research this issue. The task force is also addressing the conflicts between minimum funding rules (which promote pension security and help the PBGC) and maximum deductibility rules (which are for revenue concerns).

The funding rules need to be simplified. For example, there are 11 different amortization periods/rules[11] for paying off liabilities in the funding rules in IRC §412(b) and two more in §412(l), while the accounting standards only have 3 rules (working lifetime, retiree lifetime, and period benefited for frequent amendments). In addition, these funding rules cause problems. They allow employers to improve retiree benefits (which are payable over 10 to 20 years) and pay for the improvement over 30 years, which hurts a pension plan's funding levels. On the other hand, underfunded plans must pay off their deficit in 3 to 7 years, so contributions can be very volatile when plans go from 30-year funding rules to 7-year funding rules.[12] In fact, the volatility was even more dramatic for plans that were prohibited from making deductible contributions in the late 1990s, and now must fund their deficits over 7 years (see the attached chart labeled "Current Funding Rules"). This problem did not happen when the rules were implemented. In the 1980s, current interest rates were much higher, so the full funding limit was much higher than current liability, and the funding rules allowed plans to create surplus margins in their plans. Today, however, the full funding limit (FFL) can be less than the unfunded current liability for some plans (e.g., hourly plans which cannot project benefits). This makes it difficult for them to create a surplus to get them through difficult times. Employers may not have wanted to increase surpluses in the past due to the high reversion tax, but recent experience has taught them the value of having a surplus in their plan. (See the last chart on allowing contributions in good years.) Here are some specific suggestions:

(a) Faster Amortization: The funding rules could be simplified, strengthened, and made less volatile with one change – reduce the number of amortization periods. The funding rules in §412(b) could use something less than the 20 and 30-year periods, but more than the 5-year period for experience gains and losses (which cause volatility). Accounting rules already require a shorter period for expensing, so plans may be ready for this change. Unfunded retiree liabilities and frequent benefit improvements could be amortized faster if desired, which would

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[10] Also see our April 30, 2003 testimony on this subject before the Ways & Means Subcommittee on Select Revenue Measures at http://www.actuary.org/pdf/pension/funding_testimony_043003.pdf.
[11] If multiemployer rules are counted separately.
[12] In addition, the liabilities are calculated much more conservatively.

be a simpler and better way to handle mature plans than using yield curves. This rule would also be closer to the rules for underfunded plans, but some additional smoothing may be needed to phase into them. Faster amortization would also address the concerns that PBGC has with large credit balances eliminating deficit reduction contributions.

(b) Greater Deductions in Good Years: In addition, to provide more flexibility between the minimum and maximum rules, a plan should always be allowed to deduct the normal cost (unless the plan is very overfunded), or enough to avoid a variable premium to the PBGC. One way to do this would be to allow deductions up to, for example, 130 percent of current liabilities, or the full funding limit if greater. Alternatively, the full funding limit could use end of year assets (which would enable employers to make contributions to avoid a hit to equity that SFAS 87 might impose).

Contributions are not deductible (and are subject to a 10 percent excise tax) when plan assets exceed maximum tax-deductible limits. Congress has addressed this problem to some extent by allowing a deduction for the full amount of the unfunded current liability – but even this has not been enough to prevent the current shortfall in pension funding experienced by many employers.

When current interest rates are low,[13] the deductible limit provides little or no margin for adverse fluctuations in assets or liabilities and, in many cases, as discussed later in this testimony, does not even include liabilities for benefits the plan is committed to provide. Over the past three years, we have seen a significant decline in the funded status of plans – both because the market value of plan investments have fallen, and because liabilities have increased due to lower discount rates.

Thus, we suggest policymakers consider allowing sponsors to deduct contributions until the plan is funded to some higher amount such as 130 percent of current liability (without smoothing).[14] This 30 percent margin would have covered all but two periods in the last 100 years: the depression years (dramatic decreases in stock prices) and the past two years (dramatic decreases in stock prices and decreases in interest rates). If policymakers want the margin to cover an event like this recent period, then 165 percent would be needed.[15] We

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[13] When current interest rates were higher, the full funding limit provided a more generous margin above termination liability. Today, however, current liability interest rates are much lower. If current liability interest rates are below valuation rates (which is possible if they equal 105 percent of a current Treasury rate), the full funding limit of an hourly plan (or even some salaried plans with mostly retirees) can be less than termination liability (because they can not project benefit improvements), so they have no margin for adverse fluctuations. And these are the very plans that are more likely to be underfunded now.

[14] This can be accomplished by replacing the words "current liability" with the words "130 percent of current liability" in §§404(a)(1)(D) and 404(a)(7)(A), and defining it using the current interest rates, not smoothed ones.

[15] What should this margin be? A frozen plan funded to 100 percent of termination liability (TL) on 1/2000 could be close to 50 percent funded on 1/2003. The calculations are as follows: $100 of assets in 2000

recognize the need to balance concerns about pension security with concerns about the revenue impact; to address this perhaps a lower percentage could be used or the use of 130 percent could be restricted (to plans covered under Title IV of ERISA, for example). Other ways to improve funding are:

- Allow full projection of future benefits. For example, projecting future increases in benefit and compensation limits would be very helpful in improving funding levels for plans where many participants have large benefits (such as pilot plans).
- Allow hourly plans to amortize benefit improvements faster or fund beyond current liability. Otherwise these plans are always funding benefit increases in arrears, and are always underfunded.
- Recognize lump sums in current liability. Otherwise, plans cannot fund to the benefits that they may actually have to pay.

These ideas and others will be in a paper that we are writing on improving the maximum deductible rules.

(c) Asset Withdrawals: Another conflict in the funding rules is caused by the excise tax on reversions. If employers were to contribute a surplus to the plan, and then asset returns exceeded expectations, their pension plans could have more money in them than they would ever need. However, it is difficult for employers to use those surplus funds, unless they terminate the plan (which hurts employees), and pay about 90 percent of the surplus in taxes, which makes it uneconomical. Reversion taxes were implemented in the 1980s to stop corporate raiders from taking the pension surpluses, and some groups still oppose reversions. However, some restrictions could be placed on reversions that might satisfy both parties and avoid the problems of the 1980s, such as:

- Only allow a withdrawal if the assets are unusually high, such as in excess of 150 percent of current liability (or the FFL if greater).
- Set the excise tax so that it offsets the tax advantage the funds received while in the plan. An excise tax under 15 percent could be justified now, due to recent changes lowering tax rates on dividends and capital gains.
- Allow withdrawals only for other employee benefits.
- Require consent by the collective bargaining unit, if the plan is bargained.

(3) Revise Congress' budget rules to reflect future tax revenue received on pensions. Changing the funding rules may cost the government revenue. Whenever Congress tries to improve retirement security by strengthening pension funding or by increasing pension coverage to the part of the working force without pensions, current budget rules show the loss in revenue today for the higher contributions and the larger assets sheltered. But this misses the point that pensions are tax-deferred, not tax exempt. Thus, tax revenue will increase beyond the budget window and pay back the revenue loss due to higher contributions

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would be $82 1/2003 (assuming a typical 70 percent allocation to stocks and 30 percent to shorter bonds). In addition, due to interest rates dropping by almost 200 basis points since 2000, $100 in liabilities could be over $150 today, so the funding ratio could be about 50 percent now.

If the budget rules could reflect the additional tax revenue in the future, it would be easier to pass solutions to the pension funding and coverage problems. The budget rules already reflect income beyond the 10^{th} year under the Credit Reform Act of 1990 for government loans by offsetting the payments received in the out years for housing loans, school loans, rural electrification loans, the Disaster Loan fund, loans for rural development, the Business Loan Investment Fund, mortgage guarantees, international aid, the Export-Import Bank, foreign military sales, and the Overseas Private Investment Corporation. The reason behind passing the Credit Reform Act was similar: it helped Congress make the best financial decision when deciding whether to provide loans or loan guarantees. This rule change could help Congress make better changes to pension law.

(4) Clarify the laws for hybrid plans. Hybrid plans (e.g., cash balance and pension equity plans) have been around for almost two decades, but the laws and regulations have not been updated to handle these new kinds of retirement plans. Consequently, new rules are being created through court decisions, which try to adapt the old rules to the new plans. Since there has been no clear guidance from Congress to the courts, some employers are falling into traps that did not exist when they set up their plans. A preferred way to handle this problem would be to legislate a solution that applies prospectively. Employers want to follow the rules; they just need to know what they are.

When age discrimination rules were created, they provided different rules for DB and DC plans. Hybrid plans were not on the radar screen. Since they are DB plans that look somewhat like DC plans, it makes sense in certain situations to apply DC rules to them. Without this accommodation, some people have suggested that age discrimination rules prohibit a cash balance plan with the same pay credits for everyone, even if such a plan exactly mimicked a legal DC plan (including investment returns). That does not seem to make good policy sense. On the other hand, a solution to treat hybrid plans as DC plans can create cliffs between traditional DB plans and hybrid DB plans, so another possible solution might be to have one set of rules that apply everywhere. This could make sense, because it can be difficult to distinguish between DB, DC, and hybrid plans. However, cash balance plans that replace a traditional DB plan, may desire to maintain some characteristics from the DB plan, such as subsidized early retirement benefits, so in certain situations, they will need DB rules.

(5) DB-K and Leveling the Playing Field: One way that would greatly level the playing field would be to simply allow DB plans to have 401(k) features.[16] This "DB-K" plan could have many of the advantages of DB and DC plans in one plan. For example, part of the pension plan could look like a 401(k) to employees (with pre-tax employee contributions and employer matches) but also still allow employers funding and design

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[16] Congress could revise IRC Section 401(k) to allow 401(k) features in DB plans. For example, add the words "defined benefit plan" to the first sentences of IRC Sections 401(k)(1), 401(k)(2), 401(k)(2)(B)(i)(III) and (IV), and 401(m)(1), and add a sentence to 401(k) that Treasury will specify in regulations how the words "contributions" and "deferrals" can include pay credits to DB plans. Other sections of the law may also need revisions.

flexibility of a DB plan. Employers could promise investment returns based on corporate bond rates and/or stock returns. The assets of the 401(k) portion could be held separately from the DB assets or merged with them. Our ideas contemplate one trust fund where all assets are available to pay all benefits.[17] However, these ideas are compatible with other DB-K proposals that contemplate a separate pool of assets. Here are some DC features that DB plans should have:

- Pre-tax employee contributions or deferrals (government DB plans have them through Section 414(h) pickup rules);
- Matches (hospitals and other non-profits can have matches in their DB plans);[18]
- Additional matches from the government for low-income employees (as in DC plans);[19]
- A small-business tax credit for starting new plans (just like the one for new DC plans);[20]
- Better returns than Treasury rates,[21] including returns based on stock and bond indexes;
- Safe harbors (using benefits or pay-related credits in cash balance plans, and/or cash matches) which could provide some regulatory relief; [22]
- Immediate participation at hire without affecting ADP and ACP rules;[23]
- Automatic elections;
- Phased retirement at age 59½, which a 401(k) can have pursuant to IRC 401(k)(2)(B),[24]
- DC accrual rules and the ability to test greater of benefit formulas separately.

The issue on phased retirement is a major one. Please see our paper on this subject at http://www.actuary.org/pdf/pension/irs_30dec02.pdf.

DB-K Plus plans could have features from DB plans, in which policy-makers have expressed a renewed interest, such as:

- Automatic qualified joint and survivor annuities as the default option;
- Reduced administrative expenses;
- Funding, investment,[25] and design[26] flexibility;

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[17] A complete discussion of DB-K can be found at http://www.actuary.org/pdf/pension/dbk_jan03.pdf.

[18] Revise IRC 401(k)(4)(A) to include DB plans.

[19] Revise IRC 25B to include pay-related credits in DB plans.

[20] Revise IRC 45E to include DB plans

[21] Revise IRC 417(e) to allow account-based DB plans with market-related returns to pay just the account at termination of employment. Another way to do this is to define the account as the accrued benefit.

[22] Include DB plans in the IRC 401(k)(12)(C) safe harbor, with the same rules for account-based DB plans, and allow Treasury to define the equivalent accrual for traditional DB plans (e.g., a ¾ percent pension accrual could be equivalent to the 3 percent rule in the 401(k) safe harbor).

[23] Include DB plans in IRC 401(k)(3)(F).

[24] We suggest allowing phased retirement at age 55 or after 30 years of service.

[25] For example, it is difficult for a DC plan to invest in real estate and other hard-to-value assets. The move from DB plans to 401(k)s hurts the industries thus affected.

[26] For example: early retirement windows, good benefits for all employees through an account-based formula at young ages and a traditional DB pension formula at older ages (using a greater-of-formula), portability credits (cash or benefits) from prior jobs or prior service, COLA purchases from the account side, transfers from account side to pension side at benefit commencement to buy a level pension.

- Guarantees (if the employer so desires, possibly for a charge); and
- PBGC guarantees.

Other rules will be needed to ensure that these plans are viable for employers and employees, such as:

- Separately applied maximums to DB and DC parts;[27]
- Ability to revise investment credits/guarantees in the future;
- Ability to move benefits from the DB to the DC side and vice-versa;
- Rules on conversions from current plans; and
- Simple funding rules appropriate for account-based plans.

Other ways to level the playing field can be found in my in my testimony before the U.S. Department of Labor's ERISA Advisory Board (available on the Academy's website at http://www.actuary.org/pdf/pension/ERISA_071701.pdf).

(6) Allow employers to raise the pension plan's normal retirement age. Currently, a pension plan cannot raise its normal retirement age above 65. Congress has already raised the retirement age for Social Security. It is inconsistent with Congress' pro-work policy for older Americans for the retirement age for pension plans to be kept at age 65. Allowing pension plans to use the same normal retirement age as Social Security would make sense.

Conclusion

DB plans were once the most common way of providing retirement security to America's workers. However, due to the non-level playing field created by pension laws, many employers have switched to 401(k) plans, which do not provide the same level of retirement security as traditional DB plans. One way to level the playing field is to allow DB plans the same flexibility as 401(k)s. Other ideas (such as fixing the discount rates and simplifying the minimum funding rules[28]) are discussed in my testimony, and I would be glad to analyze the effects of any proposals you wish to consider. Thank you for the opportunity to share my views today.

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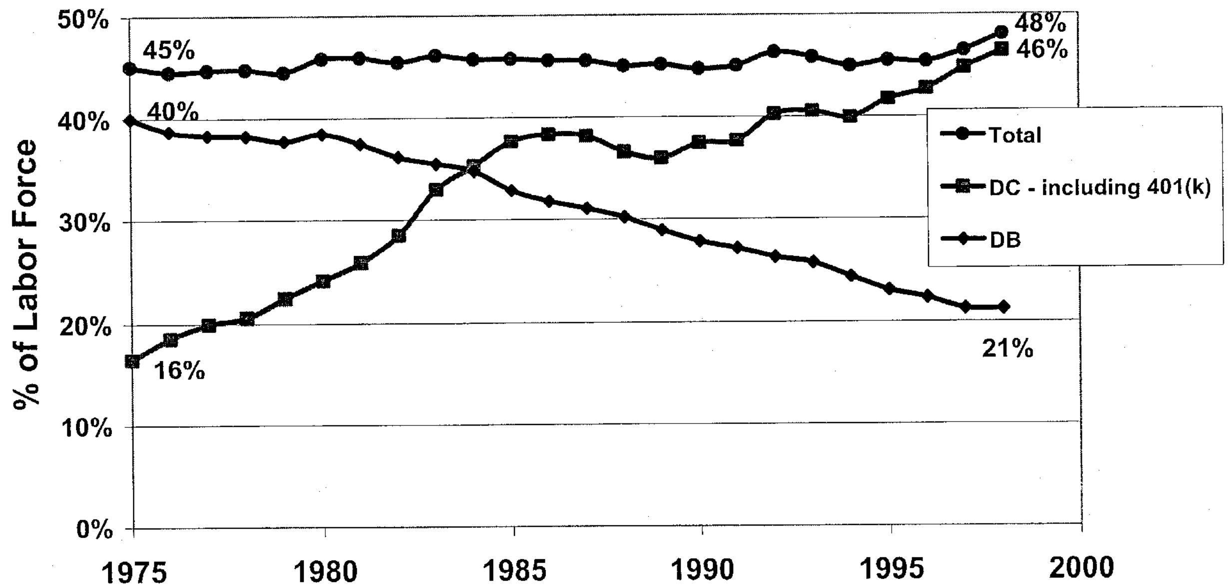
[27] Clarify IRC 414(k)(2) so that employers could designate whether a pay credit is tested as DB or DC for Section 415 purposes.

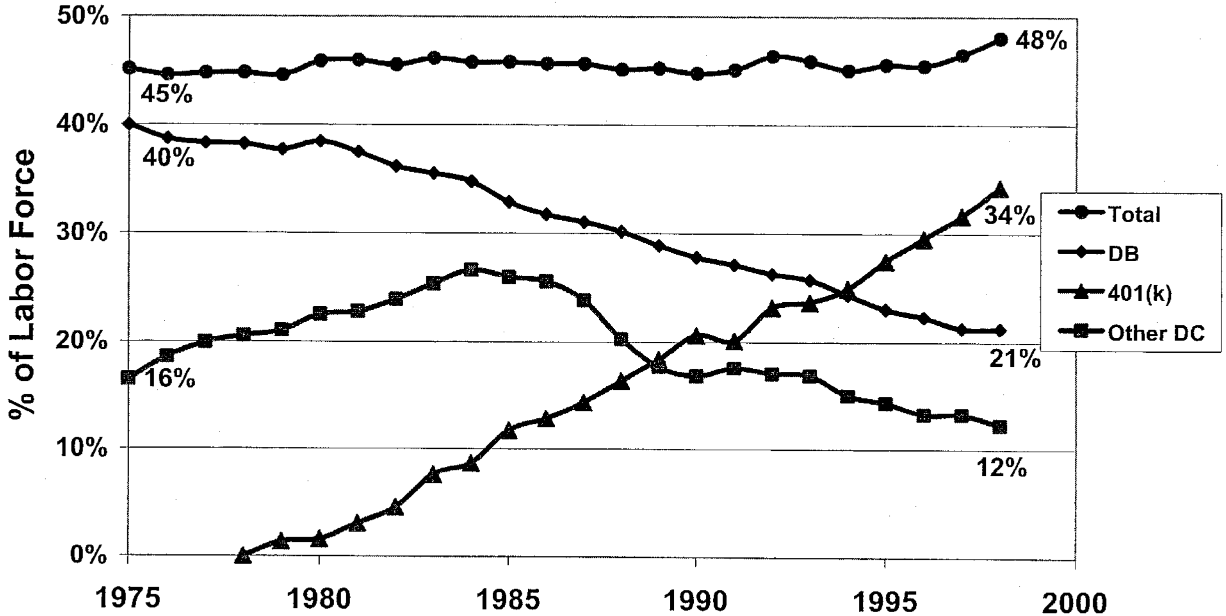
[28] Also, see the suggestions in my testimony before the U.S. Department of Labor's ERISA Advisory Board (available on the Academy's web site at http://www.actuary.org/pdf/pension/ERISA_071701.pdf).

Chart I - Participation Rates in Pension Plans (by type)



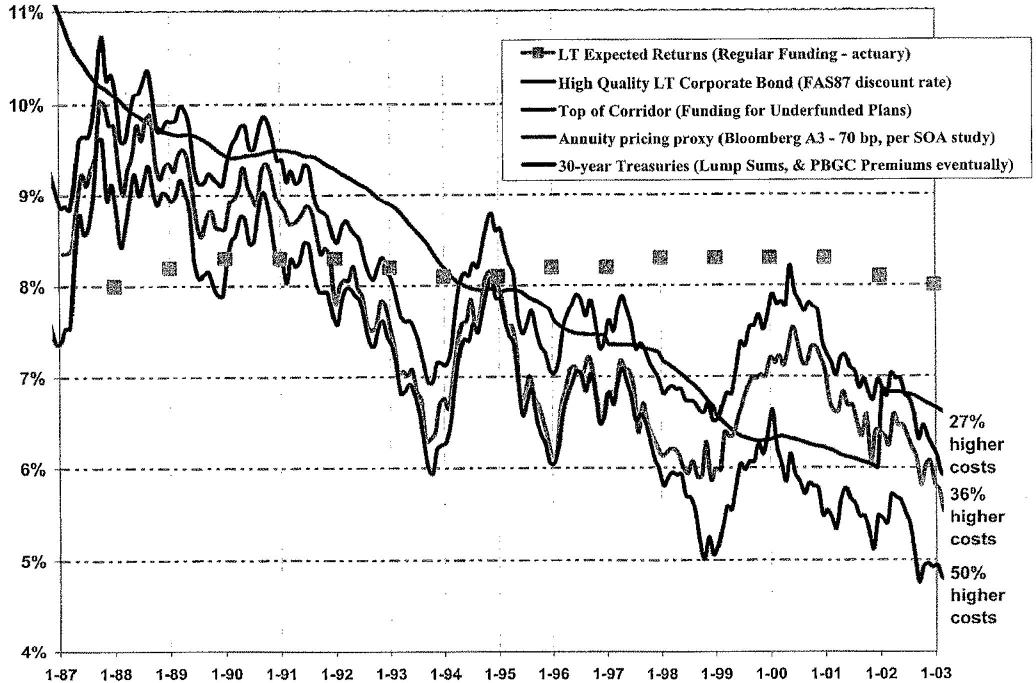
About half of the labor force participates in a pension plan, and almost all of them are in a DC-type plan (for some it's on top of their DB plan). Note: Don't add % in DC and DB, because some workers are in both.
Sources: Workers from BLS statistics: employed (FT & PT) and unemployed wage & salary workers.
Coverage from DOL/PWBA Abstract of 1998 Form 5500 data (Winter 2001/2002) Tables E4 & E8.

Chart II - Participation Rates in Pension Plans (by type)



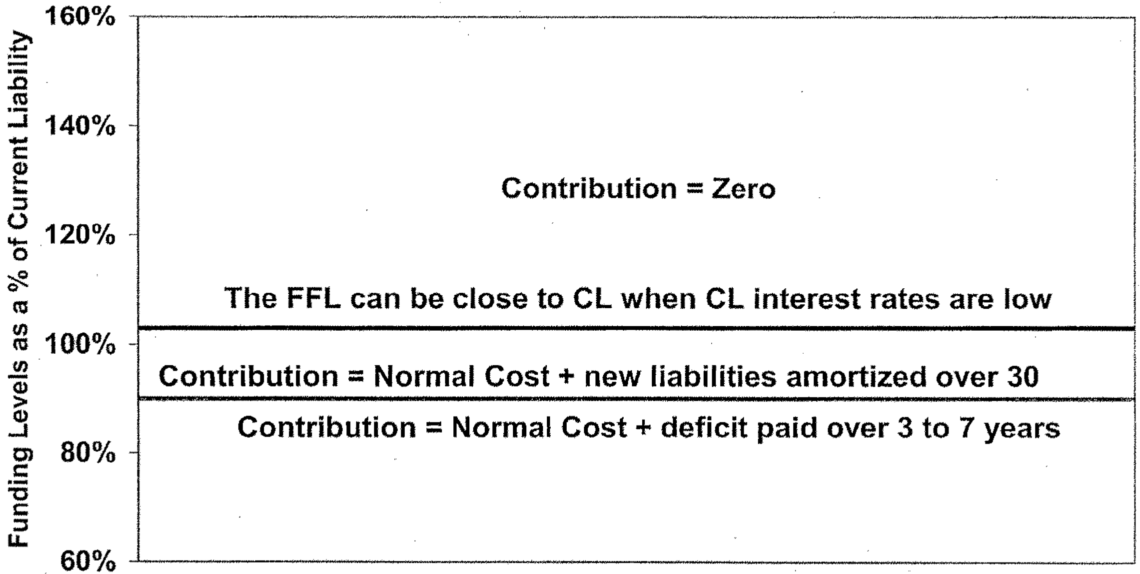
It's not a battle between DB and DC. It's a battle between 401(k) and the others, and 401(k) is far ahead. Why? Favorable laws for 401(k), especially pre-tax contributions and match.
Sources: Workers from BLS statistics: employed (FT & PT) and unemployed wage & salary workers. Coverage from DOL/PWBA Abstract of 1998 Form 5500 data (Winter 2001/2002) Tables E4, E8, & E23.

Choices for Discount Rates



Choices for discount rates in paper by American Academy of Actuaries: Long Term Expected returns, HQ Corporate Bond returns, Annuity Prices, and Treasury rates. They produce the costs indicated (relative to LT Expected Returns used for funding), assuming an average pension plan (with duration around 12). The expected returns are from Watson Wyatt surveys.

Current Contribution Rules



For many plans, the original ERISA contribution rules (normal cost + new benefit liabilities amortized over 30 years) now only apply in a very small range (plans with current liability funding levels between 90% and 100%). The new deficit reduction contribution rule applies when the funding ratio is under 90% (unless the 2 consecutive prior years or 2nd and 3rd prior years were above 90%) and always applies when the funding ratio is under 80%. It is like converting a 30-year mortgage to a 5-year mortgage (although the bank does not have to do that because it has security for the loan).

AMERICAN ACADEMY *of* ACTUARIES

Ron Gebhardtsbauer, Senior Pension Fellow

As senior pension fellow of the American Academy of Actuaries, Ron Gebhardtsbauer promotes sound pension and tax policy by providing Congress and federal officials with nonpartisan technical assistance. As the chief spokesman for U.S. pension actuaries, he leads the actuarial profession's public education program about Social Security and has emerged as a leading source of objective information.

Before assuming his Academy post in 1997, Gebhardtsbauer managed the New York City retirement practice of William M. Mercer, Inc. His public sector experience includes eight years as chief actuary of the federal Pension Benefit Guaranty Corporation (PBGC), where he served the more than 1,800 pension plans it administers. As chief pension actuary at the U.S. Office of Personnel Management, he participated in creating the Federal Employee Retirement System. Gebhardtsbauer also held private sector positions with Wyatt Company and Acacia Mutual Life Insurance Company. He serves on the national board for the pension system of the United Methodist Church and the Board of the Society of Actuaries.

Gebhardtsbauer earned a bachelor's degree in mathematics at Pennsylvania State University and a master's degree in actuarial science at Northeastern University. He has taught actuarial courses at several schools and to professional groups. He is a member of the American Academy of Actuaries, National Academy of Social Insurance, the American Society of Pension Actuaries; a fellow of the Society of Actuaries; and is an enrolled actuary. Among publications by Gebhardtsbauer is the study note about PBGC issues for the Society of Actuaries.

As the chief spokesman on Social Security and pension issues at the Academy, Gebhardtsbauer has appeared at more than two dozen town hall meetings across the United States. In 1998, he was moderator of the final session of The White House Conference on Social Security.

Gebhardtsbauer has represented pension actuaries in testimony before the U.S. Senate Finance and Labor Committees, House Ways and Means Subcommittees on Social Security, Oversight, and Select Revenue Measures, and the ERISA Advisory Council of the U.S. Department of Labor. His pension expertise has been utilized by the PBGC Advisory Board, the National Commission on Retirement Policy at the Center for Strategic and International Studies, and the Joint Committee on Employee Benefits of the American Bar Association. Internationally, Gebhardtsbauer has advised the governments of Bulgaria, Poland, Romania, and Vietnam. He is regularly featured as a speaker at international actuarial meetings and sought for analysis by the news media. To contact Mr. Gebhardtsbauer by e-mail, write to **gebhardtsbauer@actuary.org**.

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Committee on Education and the Workforce

Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)

Your Name:		
1. Will you be representing a federal, State, or local government entity? (If the answer is yes please contact the Committee).	Yes	No ✓
2. Please list any federal grants or contracts (including subgrants or subcontracts) which you have received since October 1, 1998: None		
3. Will you be representing an entity other than a government entity?	Yes	No ✓
4. Other than yourself, please list what entity or entities you will be representing: American Academy of Actuaries		
5. Please list any offices or elected positions held and/or briefly describe your representational capacity with each of the entities you listed in response to question 4: Past chair of the Academy's Pension Committee. Currently, I am not an officer or in an elected position		
6. Please list any federal grants or contracts (including subgrants or subcontracts) received by the entities you listed in response to question 4 since October 1, 1998, including the source and amount of each grant or contract: None		
7. Are there parent organizations, subsidiaries, or partnerships to the entities you disclosed in response to question number 4 that you will not be representing? If so, please list:	Yes	No ✓

Signature: Ron Gebhardtsbauer Date: June 3, 2003

Please attach this sheet to your written testimony.

APPENDIX E – WRITTEN STATEMENT OF J. MARK IWRY, ESQ., NONRESIDENT SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

Testimony of J. Mark Iwry[1]

Before the Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
United States House of Representatives

June 4, 2003

Chairman Johnson, Ranking Member Andrews and members of the Subcommittee, I appreciate the opportunity to appear before you to discuss defined benefit pension plans and their important role in our private pension system.

It is my understanding that the main purpose of today's hearing is to provide the Members of the Subcommittee with background information, an overview, useful perspective and a deeper understanding of the defined benefit pension system, rather than focusing at this time on specific legislative measures. Accordingly, after providing brief background relating to the private pension system, my testimony will address the basic nature of defined benefit (DB) plans and the key differences between them and defined contribution (DC) plans, will discuss the decline in DB plan coverage and its causes, and will evaluate DB plans, including their advantages and disadvantages, within the context of our private pension system as a whole, including a number of policy implications. My testimony today will not address specific legislative proposals.

Because I have been asked to address some of these issues in congressional testimony and correspondence with Congress in the past, certain portions of this testimony draw heavily on my previous writings (often quoting verbatim), as indicated specifically in the footnotes to this written testimony.

I. The Context

In assessing our nation's private pension system, one can readily conclude that the glass is half full and the glass is half empty. The system has been quite successful in important respects. It has provided meaningful retirement benefits to millions of workers and their families, and has amassed a pool of investment capital exceeding $5.6 trillion (excluding IRAs) that has been instrumental in promoting the growth of our economy[2].

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[1] The witness is a lawyer and a Nonresident Senior Fellow at the Brookings Institution. He served as the Benefits Tax Counsel of the U.S. Department of the Treasury from 1995 through 2001. The views expressed in this testimony are those of the witness alone. They should not be attributed to the staff, officers, or trustees of the Brookings Institution or to any other organization.

[2] Board of Governors, United States Federal Reserve System, Statistical Release Z.1, Flow of Funds Accounts of the United States (March 6, 2003), tables L.119, 120. This total is as of the end of 2002. It excludes amounts rolled over from plans to IRAs as well as other IRA balances. It is unclear how much of these accumulated assets in retirement plans represent net national saving (private saving plus public saving), because this dollar amount has not been adjusted to reflect the public dissaving attributable to government tax expenditures for pensions or to reflect any household debt or reduction in other private saving attributable to these balances. See Engen, Eric and William

Some two thirds of families will retire with at least some private pension benefits, and at any given time, employer-sponsored retirement plans cover about half of the U.S. work force.[3] However, the benefits earned by many are quite small relative to retirement security needs. Moreover, moderate- and lower-income households are disproportionately represented among the roughly 75 million workers and spouses who are excluded from the system. They are far less likely to be covered by a retirement plan.[4] When they are covered, they are likely to have disproportionately small benefits and, when eligible to contribute to a 401(k) plan, are less likely to do so. (Fewer still contribute to IRAs.) Accordingly, the distribution of benefits – retirement benefits and associated tax benefits – among households by income is tilted upwards.

Yet providing retirement security for moderate- and lower-income workers – in other words, for those who need it most -- should be the first policy priority of our tax-qualified pension system. This is the case not only because public tax dollars should be devoted to enhancing retirement security as opposed to retirement affluence – minimizing the risk of poverty or near-poverty in old age, reducing retirees' need for public assistance and potentially reducing pressure on the nation's Social Security system.[5] It is also because targeting saving incentives to ordinary workers tends to be a more effective means of promoting the other major policy goal of our pension system: increasing national saving.

Tax expenditures that are of use mainly to the affluent tend to be inefficient to the extent that they induce higher-income people simply to shift their other savings to tax-favored accounts, direct to tax-favored accounts current income that would otherwise be saved in nontax-favored vehicles, or offset additional contributions with increased borrowing. But contributions and saving incentives targeted to moderate- and lower-income workers – households that have little if any other savings that could be shifted -- tend to increase net long-term saving.[6] This enhances retirement security for those most in need and advances the goals of our tax-favored pension system in a responsible, cost-effective manner.

These goals have been articulated by the Department of the Treasury in congressional testimony as follows:

Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups." NBER Working Paper No. 8032 (October 2000).

[3] Testimony of J. Mark Iwry, Benefits Tax Counsel, Office of Tax Policy, Department of the Treasury, before the Committee on Health, Education, Labor and Pensions, United States Senate (Sept. 21, 1999)("Sept. 21, 1999 Testimony").

[4] It has been estimated that over 80% of individuals with earnings over $50,000 a year are covered by an employer retirement plan, while fewer than 40% of individuals with incomes under $25,000 a year are covered by an employer retirement plan. See Testimony of Donald C. Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, before the House Committee on Ways and Means, Subcommittee on Oversight, page 6 (March 23, 1999) ("March 23, 1999 Testimony").

[5] March 23, 1999 Testimony (cited at note 4, above), page 3.

[6] See Engen and Gale (2000), cited at note 2, above.

> "First, tax preferences should create incentives for expanded coverage and new saving, rather than merely encouraging individuals to reduce taxable savings or increase borrowing to finance saving in tax-preferred form. Targeting incentives at getting benefits to moderate- and lower-income people is likely to be more effective at generating new saving....
>
> "Second, any new incentive should be progressive, i.e., it should be targeted toward helping the millions of hardworking moderate- and lower-income Americans for whom saving is most difficult and for whom pension coverage is currently most lacking. Incentives that are targeted toward helping moderate- and lower-income people are consistent with the intent of the pension tax preference and serve the goal of fundamental fairness in the allocation of public funds. The aim of national policy in this area should not be the simple pursuit of more plans, without regard to the resulting distribution of pension and tax benefits and their contribution to retirement security....
>
> "Third, pension tax policy must take into account the quality of coverage: Which employees benefit and to what extent? Will retirement benefits actually be delivered to all eligible workers, whether or not they individually choose to save by reducing their take-home pay?"[7]

There are a number of reasons why the system is not doing more to address the needs of moderate- and lower-income workers.

First, tax incentives – the "juice" in our private pension system – are structured in such a way that they prove to be of little if any value to lower-income households. An exclusion from income for contributions to a plan, earnings on those contributions, or distributions of the contributions and earnings, and a tax deduction for contributions are worth little to the roughly three quarters of our population who are in the 15%, 10% or zero income tax brackets. (Refundable tax credits – or even nonrefundable tax credits such as the saver's credit for 401(k) and IRA contributions under section 25B of the Internal Revenue Code -- would help address this problem.)

Second, and more obviously, after spending a higher proportion of their income on immediate necessities such as food and shelter; lower-income families often have little if anything left over to save.

Third, lower-income families have less access to financial markets and credit and tend to have little if any experience with tax-advantaged financial products, investing and private financial institutions.

Fourth, the qualified plan rules do not require coverage of many part-time workers.

II. Tax Expenditures for Pensions

Pensions can be viewed as increasing national saving to the extent that the saving attributable to pensions (net of any associated borrowing or other reductions in other

[7] March 23, 1999 Testimony (cited at note 4, above), pages 3-4.

private-sector saving) exceeds the public dissaving attributable to the tax preferences for pensions. Those tax preferences represent a significant investment by the taxpayers. The Treasury Department has estimated the cost of the tax-favored treatment for pensions and retirement savings – the amount by which the pension tax advantages reduce federal tax revenues -- as having a present value of $192 billion. Of the $192 billion total, some $100 billion is attributable to defined benefit plans and defined contribution plans other than section 401(k) plans, $81 billion to 401(k) plans, and $11 billion to IRAs.[8]

This present-value estimate is designed to take into account not only the deferral of tax on current contributions and on earnings on those contributions but also the tax collected when the contributions and earnings are distributed in the future, whether within or beyond the "budget window" period.[9] Because large portions of the defined benefit plan universe are in each of the private sector and the public (mainly state and local government) sector, a significant percentage of the tax expenditure for non401(k) pensions is attributable to the plans in each of those sectors.

III. Defined Benefit Plans and Defined Contribution Plans

A. DB and DC Plans in General[10]

The Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 (Code) draw a basic distinction between defined benefit and defined contribution plans. Both statutes define a defined benefit plan essentially as a pension plan that is not a defined contribution plan, and define a defined contribution plan as one "which provides an individual account for each participant and for benefits based solely on the amount contributed to the participant's account and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account."[11]

Under these definitions, in order for a retirement plan to be a defined contribution plan, all assets in the plan must be allocated among the individual accounts which are maintained for each participant. Each year, the allocable share of the plan's investment return is added to a participant's account together with the participant's share of any contributions or forfeitures. The contributions typically will be a fixed percentage of pay for all participants, or may vary in accordance with an employee's cash or deferred election under a 401(k) plan. By contrast, under a defined benefit plan, a participant's benefit is determined under a plan formula and is independent of the investment return. Thus, under a defined benefit plan, the employer bears the risk of investment return; under a defined contribution plan, the employees bear that risk.

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[8] Budget of the U.S. Government, Fiscal Year 2004, Analytical Perspectives, Table 6-4, page 112 ("FY 2004 Budget, Analytical Perspectives"). The budget documents also contain other tax expenditure estimates that are based on alternative methods.
[9] FY 2004 Budget, Analytical Perspectives, page 102.
[10] The material in this section A is quoted essentially verbatim from the witness's Sept. 21, 1999 Testimony (pages 3-4), cited at note 3, above.
[11] ERISA sec. 3(34), 3(35); Code sec. 414(i), (j).

The traditional models used for DB plans and DC plans have given rise to significant economic differences between the types of plans that transcend the legal distinctions. As noted, DC plans provide for contributions allocated each year to each participant, while DB plans typically state a benefit promise in terms of an annual benefit commencing at normal retirement age. This has led to a difference in the pattern under which the ultimate economic value of plan benefits is typically earned or accrued under the two types of plans.

Under a traditional DB plan that provides for an annuity benefit generally based on final average pay (e.g., 1% of highest average pay times years of service), a participant typically will earn the most valuable benefits later in his or her career. The surge in benefit value under a final average pay DB plan occurs for a number of reasons. First, a retirement benefit expressed as a fixed annuity payable at retirement is more valuable to a worker who is closer to retirement age than to a younger worker. This first difference applies both in the case of a final average pay plan and in the less common cases of a career average pay plan or a flat benefit plan.

A second reason for the benefit value surge in a traditional final average pay plan is that the annuity benefit is computed with reference to highest average pay which is typically earned in the worker's final years of employment. As a worker's pay increases, it causes an increase in the plan benefits that were earned in prior years (which were based on the worker's pay in those prior years), and the amount of this increase in prior benefits is proportional to the number of past years of service under the plan. Because older workers tend to have longer service, they will derive the greatest value from this final average pay feature. A third reason is that a DB plan may offer a subsidized early retirement benefit to employees who retire after a specified number of years. When an employee satisfies the eligibility conditions for the subsidy, the value of the employee's benefit can increase considerably.

In contrast, DC plans provide a more ratable accrual. If two employees of different ages receive the same allocation to their individual accounts, the current economic value is the same. In addition, contributions made to an employee's account are based on the current year's pay. Thus, unlike the case of a DB plan that bases benefits on final average pay, in a DC plan there is no retroactive increase in past contributions to reflect the excess of current year's pay over past years' pay. DC plans also do not provide for early retirement subsidies.

Hybrid plans, such as cash balance pension plans are plans of one type – DB or DC – that also have characteristics of the other type. In some respects, cash balance plans resemble DC plans. They are presented to employees using DC plan concepts, with an account that increases over time as a result of interest and compensation credit. In addition, the pattern of economic accrual under a cash balance plan (i.e., each employee is credited with a hypothetical allocation which is a percentage of that employee's compensation for that year) is closer to the economic accrual under a traditional DC plan than under a traditional DB plan design. However, a cash balance

plan is not a DC plan because an individual's benefits under a cash balance plan are not solely derived from the individual's allocated contributions plus attributable investment return. Therefore, cash balance plans are DB plans.

B. Basic Classifications of DB Plans

The universe of defined benefit plans may be classified in various ways. One way is by type of plan sponsor and covered workforce. Three distinctions are helpful here:

- DB plans can take the form of "single employer" or "multiemployer" plans. The former type of plan is the conventional corporate plan sponsored by a single employer for its employees. The latter type, the "multiemployer" plan, is sponsored by more than one employer in a single industry where employees are represented by collective bargaining and where the plans are jointly trusteed by representatives of corporate management and of the labor union. The legal frameworks are somewhat different for the two types of plan.

- Single-employer DB plans can be maintained pursuant to collective bargaining or not. Nondiscrimination standards that are intended to prevent qualified plans from discriminating in coverage or benefits in favor of highly paid employees generally do not apply to collectively bargained plans.

- DB plans can cover employees of employers in the private-sector or in the public sector. DB plans maintained by State and local governments (and by the Federal Government) for their employees comprise a large portion of the DB universe and are generally exempt from ERISA and from some of the tax qualification rules.

As a practical matter, a fourth sponsor-based distinction that can be helpful to bear in understanding the role of DB plans in our system is the informal distinction between larger employers and small business employers. While not invariably the case, typically the dynamics of plan choice and design, operation, duration and other issues bearing on the adoption and administration of DB plans can differ significantly between the small business sector and employers with larger workforces. In formulating policy, it is important to understand the different problems, needs and perspectives of small employers as distinct from larger ones, as well as their employees.

C. DB Plan Termination Insurance[12]

Most participants in terminating qualified defined benefit pension plans receive benefit protection in the form of a plan termination benefit guarantee administered by the Pension Benefit Guaranty Corporation (PBGC), a government corporation created under ERISA.

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[12] The material in this section C has been taken verbatim (or nearly so) from an unpublished paper, "Regulation and Supervision of Pensions in the United States", prepared by the witness for the OECD in May 2002.

The PBGC pays vested pension benefits to participants monthly up to specified dollar limits. This PBGC guarantee applies only if a defined benefit plan terminates without adequate funding to pay the benefits and the employer goes out of business or is otherwise financially unable to fund the benefits. In that event, the PBGC generally steps in and takes over trusteeship of the plan and its assets in order to pay the benefits. An employer that is financially capable of fully funding a plan's benefits when the plan terminates is required to do so.

The PBGC, which covers both single-employer and multiemployer plans, is funded by insurance premiums paid by employers that sponsor defined benefit pension plans, by funds received from plans it takes over, by recoveries in bankruptcy from former plan sponsors, and by earnings on the investment of its assets. General tax revenues are not used to finance the PBGC, and it is not backed by the full faith and credit of the United States Government.

In a sense, the PBGC operates as an insurance company for pension plans. However, it has a special public responsibility to protect the interests of plan participants. The agency often acts as an advocate for participants' pension interests in negotiating with corporations that are in financial distress regarding pension plan funding and benefits in connection with corporate bankruptcy.

IV. Why Has Defined Benefit Plan Coverage Declined?

The number of defined benefit plans and the number of defined benefit plan participants have both been declining for years. However, the decline in the number of participants covered by DB plans has been relatively slight, by contrast to the dramatic decline in the number of DB plans. The difference appears to be attributable to the fact that the decline has taken place mostly in the small business sector; larger DB plans (those covering state and local government employees as well as corporate plans) have generally been more durable. Accordingly, many of the plans that have disappeared covered very few workers.[13] In addition, some number of DB plans were merged into other plans – without necessarily reducing the number of workers covered -- in connection with corporate mergers and other business combinations. Actual termination of larger DB plans appears to have been the exception, but for many years now, very few new small or large DBs have been established.

(In this portion of my testimony, I have taken the liberty of incorporating, verbatim, material from several paragraphs of a February 7, 2000 letter I wrote to Senator James Jeffords (I-Vt) when he was Chairman of the Senate Health Education Labor and Pensions Committee and I was Treasury's Benefits Tax Counsel in response to questions Senator Jeffords had posed to me concerning defined benefit plans.)[14]

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[13] D. Rajnes, EBRI Issue Brief Number 249: An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans (Sept. 2002).

[14] The discussion on pages 6-11 of this testimony includes a number of paragraphs taken verbatim (or nearly so) from pages 4–6 of the February 7, 2000 letter from the witness (then Benefits Tax Counsel) to then Chairman Jeffords.

It is commonly asserted that the continuing stagnation and decline of defined benefit plan coverage are mainly attributable to "overregulation" that added unduly to the cost and complexity associated with DB sponsorship. There is some truth to the proposition that DB plans have been made significantly more costly and less attractive to employers by such regulatory constraints as PBGC premiums (during a period when the PBGC was in chronic deficit), legal funding requirements and restrictions, vesting and accrual standards, restrictions on reversion of surplus assets to the employer, and nondiscrimination standards designed to ensure that a reasonable number of average workers receive a reasonable share of the benefits. The question, of course, is how much of this regulation, if any, has been unnecessary or excessive, and how much of an adverse impact it has had.

In my view, some of the regulation has unnecessarily discouraged employers from maintaining DB plans, partly because Congress and regulators have sometimes struck a questionable balance in seeking to prevent abuses that have arisen in the past. In some instances, abuses that have occurred on occasion in the small business environment have prompted overly broad restrictions equally applicable to larger plans where the particular risk is highly unlikely to arise.[15] In other cases, requirements that might have been reasonable in the larger plan context were imposed equally on small plans where the associated costs, which could not be spread over numerous participants, made the requirements harder to justify.

More generally, employers and their advisers have expressed concern about the volatility and unpredictability of their ongoing DB funding obligations from year to year. Because the funded status of a plan depends on a comparison of its liabilities (calculated based on assumed interest rates, among other things) and its assets, the natural fluctuations of interest rates and asset values, as they interact with statutory or regulatory restrictions, has caused variability in funding.

At the same time, much of the regulation that caused employers to drop DB plans brought about reasonable reforms in the law. A considerable number of plans were appropriately terminated as a result of the Tax Reform Act of 1986 because they were viewed as abusive or not delivering fair "money's worth" to the taxpayers. The 1986 legislation ruled out or discouraged certain aggressive defined benefit pension practices that had been prevalent for years. This shrinking of the owner's or employer's net pension and tax benefit from DB plans (net of the cost of providing benefits to employees and paying PBGC premiums and administrative costs) led to the termination of many plans in the small business sector that had limited most of the benefits to the owner of the business, while delivering comparatively little to ordinary workers. For example, the legislation had the effect of ruling out defined benefit plans covering only a single, highly-paid partner or other co-owner of a professional firm to the exclusion of support staff and other employees. This caused the abandonment of numerous such plans.

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[15] Testimony of Kenneth Porter on behalf of the American Benefits Council, before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (April 30, 2003).

The reforms included in the 1986 legislation also prohibited the practice of completely eliminating tax-qualified pension benefits for moderate- and lower-paid workers by "offsetting" their expected Social Security benefits against their plan benefit formula. In the late 1980s and early 1990s, many employers amended such fully "integrated" defined benefit plans, which had previously "zeroed out" benefits for rank-and-file employees, to conform to the newer, less lenient nondiscrimination standards. But some employers instead chose to terminate plans that involved this or other features that were prohibited pursuant to the 1986 legislation or implementing regulations.

In addition, in the 1980s, many employers terminated defined benefit plans in order to obtain surplus plan assets for use in corporate takeovers or for other general corporate purposes. The Tax Reform Act of 1986 imposed an excise tax on pension reversions to discourage them and to recapture tax benefits that had been obtained on reverted assets. Congress later increased the excise tax. In addition to employers that terminated their defined benefit plans and recovered surplus assets before the 1986 legislation, others took these steps shortly before the excise tax took effect or in anticipation of increases in the excise tax.

It is unclear, however, that regulation – whether justified or excessive – has been the driving factor behind the stagnation and decline of DB coverage. In fact, a variety of causes have contributed to the decline. Broad, secular trends in society, the marketplace, and the workplace appear to have accounted for much of the change.

One such trend has been the decline in the expectation that workers will tend to stay with a single employer for their entire career. To the extent that employees and employers have had a perception that workers tend to change jobs more often and thus stay in each job for a shorter time, there may have been less demand for plans that deliver the preponderance of their value to long-service employees when they approach the end of their career with the employer.

Accordingly, in recent years there appears to have been considerable employee demand for plans that state benefits in the form of an account balance and emphasize "portability" of benefits – the ability to preserve and continue accumulating a pension despite changes in employer or work status. These have included, for example, plans that vest employees in their benefits earlier, provide more substantial benefits to shorter-service workers, and offer lump sum distributions that can be rolled over to a new employer's plan or to an IRA.

Another relevant trend is the change in the mix of jobs in the economy as a whole and the decline in the percentage of the work force that is unionized. Traditionally, defined benefit plans have been commonly maintained in the public sector – particularly plans covering employees of state and local governments – as well as in unionized work

forces, typically in industrialized sectors of the economy, such as manufacturing.[16] Employment in manufacturing generally has been outpaced by growth in the service sector, where collective bargaining is less prevalent. Service workers (whether mobile, high-tech workers or lower-paid employees of fast food restaurants or retail outlets who are short on cash) are less likely to ask their employers for defined benefit plans. Many employers in service industries provide no retirement plans to their employees; and when these employers do offer plans, they have tended to sponsor defined contribution plans instead of plans that target benefits to longer-service employees (as traditional defined benefit plans do). Once some of the competitors in an industry fail to offer defined benefit plans, the comparative costs become an issue for other competitors.

In addition, at one time the high correlation between union representation and DB coverage was viewed as indirectly expanding DB coverage for nonunion workers. Some employers might have adopted DB plans in an effort to preempt unionization of their work force, while others adopted DBs for their nonunion salaried employees in order to give them benefits comparable to those bargained for by hourly represented employees. But as the unionized percentage of the work force has declined, employers may have had less reason to adopt DBs for their nonunion employees.

A fundamental demographic trend has raised the cost of funding defined benefit plans, thereby making them harder to afford: increased longevity combined with earlier retirement. It has been estimated that the average male worker spent 11.5 years in retirement in 1950, compared to 18.1 years today.[17] This means that the life annuities provided by defined benefit plans are paid for a far longer period, and the lump sums these plans provide are significantly larger, as they generally are based on the actuarial present value of the life annuity.

This cost increase has occurred while U.S. businesses have faced intense competition from firms overseas (and in this country) that, more often than not, do not incur the expense of offering a defined benefit plan. This would not necessarily have resulted in a decline in DB coverage had there been more broad-based worker demand for DB plans. But the increasing sense of global competition coincided with another powerful trend, which affected employee demand for pensions: the advent of the 401(k) plan and its dramatic growth and popularity beginning in the early 1980s.

Indeed, the trend from DB to DC plans is more meaningfully viewed as a trend from employer-provided, employer-funded pension benefits to employee self-funded individual retirement savings through 401(k) accounts and IRAs – a trend that has broad and significant implications. Employers generally have not switched from DB plans to their closest DC analogues, the employer-funded money purchase pension plan or "profit-sharing" plan (which in fact is not required to be based on profits and can instead

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[16] The 1998 Pension Benefit Guaranty Corporation Pension Insurance Data Book (Table S-18) showed that over half of the 33 million participants in single employer defined benefit plans insured by the PBGC were covered by plans sponsored by employers in manufacturing industries.

[17] Testimony of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation, before the Subcommittee on Select Revenue Measures, House Ways and Means Committee, April 30, 2003, pages 7-8.

provide a fixed percentage-of-pay employer contribution every year). Instead, the move has been to "cash or deferred" salary reduction arrangements under section 401(k) of the Internal Revenue Code.

A switch from to DC money purchase or profit-sharing plans might have been expected if the DB decline had been caused chiefly by DB regulatory costs such as PBGC premiums, funding constraints, and complex rules for DBs; these employer-funded DC plans are not subject to most of those costs, and are governed by a simpler set of rules. But the shift has been of a more fundamental nature: from employer-funded plans of any kind (DB, money purchase, or profit-sharing) to plans funded in large part by employees' own salary reduction contributions.

Economic theory and studies suggest that most retirement benefits ostensibly provided by employers ultimately come out of employees' total compensation package because they tend to be offset, sooner or later, by reductions in other forms of compensation. The timing and extent of these offsets may differ in different labor markets and based on other factors, as may the scope of the offsets – the extent to which they apply on an individual employee-by-employee basis or on a group basis, and the composition of the affected group of employees.[18] Assuming this view is correct, the immediate source of retirement contributions – the employer or their own salary – should not be of ultimate concern to employees collectively. However, individual employees who are eager to save might prefer the individually-driven nature of the 401(k) salary reduction decision because it enables them to avoid "subsidizing" their less interested (and perhaps less influential) coworkers through employer contributions that ultimately reduce everyone's pay and enables them to opt for a higher level of contribution than the employer might otherwise provide.

In fact, common parlance among employers and employees (outside of the collective bargaining context) suggests that many may view (or at least describe) employer-funded benefits as if they are "extra" added compensation that come at little or no cost to the employee. Nevertheless, it has become evident during the past two decades that many employees appreciate and value salary reduction 401(k) plans more than DB plans.

One reason is that traditional DBs tend to provide very small benefits to younger employees who leave the employer. Instead, traditional DBs tend to concentrate the large benefits among a relatively limited percentage of the work force who retire from the employer after a long career there. As the perception has grown that employees are increasingly mobile, interest in "portable" benefits has increased. The 401(k) responds to this interest by giving employees a benefit that they can take as a single-sum payment to spend or save when they leave their current job.

Second, and related, for all but those nearing retirement age, the tangible account balance of a 401(k) can appear to be more meaningful and easier to relate to than the

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[18] See William Gale and Peter Orszag, "Private Pensions: Issues and Options" (March 2003), forthcoming in Agenda for the Nation, Ed. By Henry Aaron, James Lindsay and Pietro Nivola,(Brookings 2003).

remote prospect of a life annuity that would not begin for many years. The DB plan is harder to understand and can be nearly "invisible" for many employees. (Moreover, if the DB plan provides only small benefits for younger employees, as is often the case, the employer may have little interest in making it visible to the younger segment of the work force.)

Third, a benefit presented in the form of an account balance may make some employees feel richer: the amount of the account balance may sound significantly larger than an equivalent life annuity to those who are not accustomed to thinking in terms of present values or actuarial equivalents.

Fourth, especially during the bull market of the 1990s, American workers grew increasingly familiar and comfortable with the stock market and mutual funds. Many, especially more sophisticated or higher-income individuals, seemed to derive pleasure or satisfaction from the process of owning and choosing how to invest their own account – at least so long as things were going well in the markets. As a result, there was less demand for defined benefit plans, where all of the investment reward (and risk) resides with the plan sponsor.

Fifth, Congress provided tax-favored treatment of employee contributions to 401(k) plans. Unlike employee contributions to DB plans, 401(k) employee contributions reduced an employee's W-2 income. Outside of the state and local government sector – where DB plans generally have been retained -- employee contributions were not very prevalent in DB plans. But the option of making employee contributions on a pretax basis was a key feature that made 401(k) plans attractive.

Finally, the 401(k) offers liquidity that DB plans cannot provide. Benefit payments from DBs generally cannot be made until an employee terminates employment with the plan sponsor (and in many cases not until retirement age). By contrast, most 401(k) plans allow employees to borrow part of the account balance and to withdrawal amounts during employment in the event of a financial "hardship" (including college tuition payments and purchase of a home).

For these and other reasons, including aggressive marketing by financial services firms providing 401(k) investments, the 401(k) plan acquired an extraordinary "branding" value. Employees came to appreciate, value and demand it far more than the DB plan, even though the DB, for many, might in fact be more valuable. Even if choosing a 401(k) instead of a DB plan did not save the employer costs (for example, because of employer matching contributions to the 401(k)), adopting a 401(k) seemed more responsive to employee demand and seemed to earn the employer more employee appreciation.

But, in some cases at least, the 401(k) would have been perceived as less costly within the employer organization. In addition to saving actuarial fees and PBGC premiums, employee salary reduction contributions might be viewed and treated quite differently from employer contributions for purposes of short-term budgeting and for purposes of

the benefits costs that the benefits and human resources function must submit for approval by the CFO. Therefore, when employees seemed value salary-reduction 401(k) plans that they funded from their own current salary more than DB plans, it was not surprising that many employers were quick to respond.

In addition to the striking success of the 401(k), another factor might have contributed to the continued low level of interest in DB plans in the small business sector. This was an increase during the 1990s in the number of highly skewed defined contribution plan designs. "New comparability" and "age-weighted" profit sharing plans marketed beginning in the 1990s could often concentrate just as great a percentage of the retirement benefits in the hands of owners or other highly paid individuals in small businesses as traditional defined benefit plans. For example, under "new comparability" plan designs, higher benefits generally could be provided exclusively to highly-paid employees. And unlike traditional DB plans, new comparability formulas did not permit rank-and-file employees to "grow into" higher levels of benefits as they aged or accumulated more service with the employer. Thus, while the vast majority of defined benefit terminations occurred in the small business sector (as evidenced by the fact that the number of DB participants declined far less than the number of DB plans), it is likely that a number of small businesses that formerly sponsored DB plans – or that might be expected to take an interest in sponsoring one – opted instead for these defined contribution plan designs.[19]

Finally, the downturn in the stock market during the past several years, unusually low interest rates, and the Treasury Department's buyback of public debt and decision to stop issuing 30-year Treasury bonds have combined to convert DB pension surpluses into deficits. Significant DB underfunding has developed because plan asset values have diminished relative to their levels during the late 1990s, while the present value of plan liabilities has increased because the four-year weighted average of interest rates on 30-year Treasury bonds, used as a basis for valuing DB liabilities, has been at an unusually low level.

These developments are imposing sudden, large funding obligations on plan sponsors and are having adverse effects on corporate financial results. As a result, while some have noted that the poor investment performance in DC plans should give employees a new appreciation of defined benefit plans, corporate CFOs have been viewing their defined benefit plans with fresh skepticism, and concern is high in the pension community about the prospect that DB plans will be "frozen" (ceasing further accruals under the plan).

[19] Treasury regulations adopted in 2001 limited to some degree the extent of the disparity in benefits permitted under new comparability plans.

At the same time, the PBGC has seen its financial position transformed from substantial surplus to substantial deficit as a number of major plan sponsors in financial distress have terminated their DB plans.[20]

V. Evaluating Defined Benefit Plans from a Pension Policy Standpoint

Defined benefit plans have important virtues as retirement programs. While not inherently superior to defined contribution plans -- many of the advantages of a DB can be replicated in a different manner through an appropriately designed DC – DB plans (traditional or hybrid) tend to have certain favorable attributes. These include automatic employer-funded contributions (as opposed to individual salary reduction) and the ability to provide a low-cost annuity.

For public policy purposes, it is not the formal distinction between defined benefit and defined contribution that matters most. It is more useful to examine the specific underlying attributes of a particular plan or plan design (which can be packaged together in different ways) and how they contribute to the desired outcomes.

Accordingly, various types of plans – DBs, DCs, hybrids, 401(k)s -- are all worth encouraging as a matter of policy, provided that they deliver quality coverage, i.e., meet the basic public policy objectives of the system. (In a sense, the Social Security system comes close to the classic paradigm of a defined benefit plan that delivers quality coverage.)

Without attempting to be exhaustive, the discussion that follows is intended to focus the evaluation of DB features in light of key policy objectives, providing a framework for considering how and to what extent particular DB attributes tend to further the ultimate policy goal of enhancing retirement security in a cost-effective manner for those most in need. To that end, it is generally desirable that retirement plans have the following general characteristics:

<u>Provide broadly inclusive automatic coverage</u>.

DB plans are capable of covering an entire work force, if the sponsor so chooses. But this is true of employer plans generally. They are particularly well suited to provide broad coverage (as compared to individual savings accounts such as IRAs).

Within employer plans, automatic (nonmatching, nonelective) benefits or contributions – such as those typically provided by DB plans -- cover all who are eligible. In effect, the employees who have a strong appetite for saving subsidize the more reluctant savers. By contrast, voluntary employee contributions or employer matching contributions that are characteristic of 401(k)s can leave many behind because they are made only for those who choose to participate. Typically, when the plan requires employees to take

[20] The complex issues relating to the appropriate way to replace the 30-year Treasury rate for funding and other purposes interest rate have been the subject of extensive legislative activity, discussion and controversy, and are beyond the scope of this written testimony.

the initiative to save, those left behind are disproportionately the lower-income employees who benefit less from the tax preferences, who have less disposable income to contribute, and who may feel that they cannot afford to save.

But DB plans are far from unique in providing automatic contributions. Those are also a feature of money purchase pension plans, profit-sharing (and stock bonus) plans, and even 401(k) plans that use automatic enrollment for employee contributions. The key distinction here is between automatic contributions or benefits and voluntary contributions that require individuals to overcome inertia, myopia, and other obstacles to action. Automatic contributions or benefits ordinarily are provided by employer plans, but Social Security – the ultimate purveyor of universal coverage in our economy -- illustrates that they can also be provided by other means.

It is worth noting that employee contributions to 401(k) plans generally have been subject to nondiscrimination standards designed to give eager savers incentives to encourage saving by their more reluctant coworkers. In contrast, IRAs (and the Administration's recently proposed Lifetime Savings Accounts and Retirement Savings Accounts) involve purely individual saving decisions.

Allocate benefits equitably, in a way that makes efficient use of the tax expenditure and is calculated to increase saving.

A plan satisfies this criterion to the extent that benefits are allocated among individuals in a progressive manner, maximizing the portion of the benefits allocated to those who most need the additional retirement security and for whom (because they are not upper-income individuals) the benefits are most likely to represent additional saving.

Here DB plans are not inherently better or worse than other plan types. However, over the years, in some professional firms and other small businesses, DB plans have often been used to deliver large benefits to a business owner at a rapid pace, in order to "catch up" on retirement saving late in the owner's career, while minimizing benefits for the owner's employees through vesting, past service credit, other aspects of the plan formula, and plan termination soon after the owner retires. Other DB plans – including many covering large work forces -- have delivered meaningful benefits to numerous ordinary workers. In the debate over cash balance plan conversions, it is often pointed out that cash balance plans tend to provide a broader allocation of benefits than traditional final average pay DB plans, less concentrated on a limited group of older employees who retire after spending most of their career with the employer. In the final analysis, the allocation of benefits depends on the particulars of the plan formula and the demographics of the workforce.

Achieve security of income by providing reasonable protection to participants from risks affecting their benefits during the accumulation phase.

The risks to benefits during the accumulation phase include the risks of forfeiture, preretirement consumption ("leakage"), inflation, underfunding by the employer, investment risk, death and disability.

Risk of forfeiture. The risk of forfeiture can be avoided by immediate or rapid vesting. DB and DC plans are not inherently different in this respect. Automatic (nonelective) employer benefits (in a DB) or contributions (in a DC) are often subjected to a longer vesting schedule, although many associate the longer vesting schedules with DB plans in particular.

Risk of preretirement consumption. DB plans, like money purchase pension plans, tend to be quite effective at preventing preretirement consumption of benefits ("leakage") because the law prohibits both types of plan from allowing withdrawals before termination of employment. Moreover, many traditional DB plans (but not cash balance plans) defer payment until retirement age, even for a participant whose employment has terminated. DC plans tend to provide more access to benefits during employment, especially where deemed necessary to encourage voluntary participation, and almost always offer payouts when employment ends.

Risk of erosion by inflation. The goal of protecting benefits from premature consumption can be in tension with the goal of protecting benefits from erosion by inflation. A final average pay DB plan (or a career average pay DB that is periodically updated for cost of living increases so as to approach a final average pay formula) protects active employees' benefits from inflation during the accumulation phase. But employees whose employment has terminated will no longer have pay increases from the employer, so their benefit, if retained in the plan, will typically be vulnerable to inflation. Alternatively, if the benefit is distributed in a single sum and rolled over to a DC plan or IRA, it can be invested so as to keep up with or outperform inflation. A DC plan tends to protect benefits from inflation even for terminated former employees who leave their benefits in the plan, insofar as investment returns provide a continuing opportunity to keep pace with and outpace inflation.

Risk of underfunding. The risk of underfunding affects only DB, not DC, plans. Because DB (unlike DC) plans are not required to be fully funded at all times, participants are exposed to the risk that the plan sponsor will ultimately experience severe financial difficulties leading to termination of the plan while insufficiently funded. However, PBGC insurance protects most DB benefits against the underfunding risk associated with DB plans.

While often cited as a distinct advantage of DB over DC plans, it is not very meaningful to consider PBGC insurance in isolation. A DC participant generally has little need for insurance from the risk that the plan will terminate without being sufficiently funded to pay benefits because DC plans are always required to be fully funded. PBGC insurance may be more usefully viewed as part of a package of DB attributes relating to funding – and a critically important element of that package. The package includes the DB sponsor's flexibility to fund over time -- flexibility that is not necessarily a

disadvantage to employees or from a public policy standpoint. Funding flexibility may be a condition that makes employers more willing to sponsor a plan that provides substantial benefits payable as annuities in a promised amount.

Investment risk. Investment risk in a DB plan is borne by the plan sponsor. However, by the same token, DB participants do not share in the benefit of any successful investment performance, and a terminated employee's DB benefit is typically exposed to inflation.

Protection from investment risk is an advantage of DB plans (from the participant's standpoint) that is often cited without noting the lack of opportunity to share in successful investment performance and without noting that similar protection generally can be replicated in a 401(k) or other DC plan through safe investments. Moreover, because DC plan investments can minimize risk while providing reasonable inflation protection, they might be a more efficient way to achieve growth consistent with reasonable safety.

On the other hand, 401(k) plans that allow participants to direct their own investments may expose participants to a different set of risks that are not present in DBs: the risk of investing poorly without the discipline and expertise of professional management; the risk, in many DC plans, of overinvestment in the employer's stock; and the costs of investing on an individualized, "retail" basis (as opposed to the economies of scale associated with collective investing).

Risk of death or disability. DB plans have more flexibility than DC plans to protect employees and their families from the risk that the employee will die or become disabled early in the accumulation phase. DC plans are generally limited to providing the surviving spouse or the disabled participant access to the account balance, which may be small if the death or disability occurs early in the participant's career with the employer.

Achieve security of income by providing reasonable protection to participants from risks affecting their retirement income during the payout (post-retirement) phase.

The analysis of the comparative advantages of DB or DC plans in protecting participants against some of the risks affecting benefits after retirement is fairly similar to the analysis relating to those risks during the accumulation phase (inflation, risk of underfunding, investment risk, risk of death). Some DB plans have protected participants from post-retirement inflation through cost of living adjustments, but DB COLAs have become relatively uncommon.

However, the payout phase brings out a key distinction between traditional DB pension plans and 401(k)s, other DCs and cash balance plans: historically, traditional DBs have been designed to provide retirement income, whereas DCs typically provide wealth accumulation, available as an account balance at termination of employment. Thus, the traditional DB typically provides security of income – by paying an annuity for the joint

lives of the participant and spouse (or for the life of the participant) -- at the expense of control and post-retirement inflation protection. The annuitants are protected from longevity risk -- outliving their benefits because they live longer than expected – as well as investment risk. Moreover, although life annuities are sometimes provided by DC plans, DC participants rarely elect them, in part because the DC plan generally must purchase the annuity from an insurance carrier at considerable cost to the participant. So the DB is not unique in its ability to provide an annuity but in its ability to self-annuitize – to pay the annuity out of the DB trust fund without having to incur the often high costs of purchasing an annuity in the individual annuity market.

Having said this, it should be noted that traditional DBs have lost some of their "DB" character insofar as they have been offering and paying lump sum distributions to participants with increasing frequency, not only at retirement age but also at earlier termination of employment. On the other hand, cash balance pension plans – commonly portrayed with considerable plausibility as the best hope for the continued vitality of DB plans – are DC-type asset accumulation vehicles that are designed to pay lump sums.

As a result, the policy arguments in favor of promoting cash balance plans are more aptly focused not on the fact that they are DB plans (and are therefore asserted to be superior to DCs by reason of DB attributes such as PBGC insurance and protection of participants from investment risk), but on the facts that they provide automatic employer contributions (which have become less common in DC plans) while exhibiting some of the advantages normally associated with DCs. (As noted, PBGC insurance, while important in DBs, is not a major advantage over DC plans, which are fully funded, and protection from investment risk can be replicated with safe DC investments.) But cash balance plans tend to allocate benefits somewhat more evenly than traditional DBs by giving more to younger employees, therefore providing benefits to terminating employees that can be larger and more portable than traditional DB benefits. Cash balance plans also tend to keep pace with or exceed inflation by providing interest credits.

From a policy standpoint, the major concern raised by cash balance plans is whether the conversion from a traditional DB is carried out in a manner that provides sufficient protection to older and long-tenured employees who are adversely affected (as discussed briefly below).

<u>Provide reasonable protection to participants' spouses and children</u>.

DB plans, like money purchase DC plans, must make the joint and survivor annuity the default distribution mode for married participants, and profit sharing DC plans are permitted to do so, but tend not to.

<u>Provide benefits that are meaningful in amount (and that are likely to achieve adequacy when combined with other resources)</u>.

When it comes to adequacy, no one type of plan necessarily has an inherent advantage. The amount of benefits depends on the plan benefit formula, and often on the participant's salary, age and years of service, or on the amounts contributed and how they accumulate. However, some would note that, when comparing automatic employer contributions to voluntary contributions to an individual retirement savings account, the achievement of adequate benefits through employer contributions does not depend on each individual's financial analysis and consistency over time in saving to the requisite level or, in general, on each individual's investment acumen.

Be "sellable", i.e., attractive to employers and employees.

Many of the policy advantages described above may be viewed by employers as costs or disadvantages that make plan sponsorship less attractive. One of the fundamental conflicts or tradeoffs in our voluntary private pension system is that features that are policy or participant advantages can discourage employer sponsorship.

Avoid adverse interactions that would reduce saving or do violence to other important policy objectives.

One attribute of traditional DB plans has been their ability to use early retirement subsidies or temporary "window plan" inducements to encourage employees to retire early in circumstances where that was the employer's objective. Such approaches need to be considered in the wider context of other national policy goals. These include concerns about the impact on the economy of artificial incentives for workers to leave the work force too early, concerns about potential age discrimination (early retirement subsidies have a special exemption under the age discrimination laws), and concerns about protecting workers and their families from the dislocation of changes in the market and employment.

In particular, formulation of policy with respect to particular types of plans needs to take into account the broader implications for national retirement saving policy. This includes sensitivity to potential adverse interactions or substitution effects that could reduce national saving or even private saving on a net basis. For example, proposals to increase dramatically the amounts individuals can contribute on a tax-favored basis to individual accounts can compete with employer plans by undermining employers' incentive to maintain plans benefiting moderate- and lower-income workers.

Provide reasonable protection for individuals' reasonable expectations.

It is appropriate for pension policy to provide reasonable protection to individuals who are harshly affected by changes in the market or in the law. Conversions of traditional DBs to cash balance pension plans, for example, have created a need to provide a reasonable measure of protection for older workers adversely affected by the transition. The difficulty of determining how to provide for transition protection without stifling innovation and creativity in the market and in pension design reflects the hard tradeoffs involved in pension policy.

VI. Measuring Specific Outcomes

Whether a particular plan design will be effective in achieving the desired policy outcomes in our voluntary system often cannot be predicted with a high degree of accuracy. One reason is "adverse selection" by employers among alternative plan designs.

- For example, a DB plan that favors older workers might provide substantial benefits in an efficient manner to a large number of moderate-income employees if adopted for a work force that has many such employees who are older or who tend to stay with the employer.
- However, in a work force consisting of an older high-income owner and two young low-paid support staff employees, the same plan design might deliver only modest benefits to those who most need them (and who are mostly likely to save more) while providing large tax-favored pension and tax benefits where they are less needed as a matter of basic retirement security.
- Similarly, a plan with 5-year vesting might benefit many or few average workers depending on the turnover pattern in the particular workforce.
- In our voluntary system, many employers, especially in the small business sector, might be expected to select among plan types so as to maximize the owner's or employer's net after-tax value from the plan -- net of the cost of providing benefits to employees.

Thus, whether a particular type of plan delivers fair value for the taxpayers may depend more on the demographic profile of the work force for which it is adopted than on the design of the plan.

One way to address the problem of "adverse plan selection" is to bear in mind that cost-effective retirement income security cannot be measured merely by the number of plans or even the number of people covered. Instead, the outcomes need to be measured with specificity -- what amounts of benefits are ultimately delivered, and to whom -- and ideally, such an approach would seek to hold plans accountable for achieving reasonable results. Most plan sponsors would not run their businesses without adequate measurement of results and accountability for them. Yet our private pension system has to a great extent avoided such measurement and accountability, largely because it comes at a price in terms of complexity and administrative cost of data collection and analysis (at least to the extent requirements are imposed on plan sponsors). Since our system is voluntary, this kind of measurement has run up against plan sponsors' natural desire for simplicity and freedom from administrative burden.

Our voluntary pension system is hard to manage and harder to reform because of these sharp tensions among conflicting objectives. But recognizing the tradeoffs clearly is an essential step in doing so.

VII. Conclusion

The nation's qualified plan system represents a major public investment in private pensions. Like an equity investor or lender in a business transaction, the taxpayers – represented by Congress and the regulators -- need to be reasonably assured of an adequate return on their investment. Plan compliance with the nondiscrimination and other tax qualification standards are the quid pro quo for this continuing infusion of equity in the form of tax-preferred treatment. And the plan qualification standards, ERISA's worker protections, and the individual pension plan documents serve a function analogous, in a sense, to the "deal" documents – the extensive and often complex undertakings and covenants, representations and warranties, and events of default that major investors use to protect their investment in an operating business or industrial enterprise.

The business investor is expected to prepare for the worst (even as it expects the best) through carefully lawyered provisions seeking to provide the most thorough protection from a wide variety of risks to its investment. The quantity and complexity of the documentation in multi-million-dollar transactions is taken for granted: the stakes are high and the need is recognized. By way of comparison, the nation's "pension transaction" involves stakes in the tens of billions of dollars and a special kind of trust: dollars entrusted to government by the taxpayers at large. Yet the "pension transaction" must surmount special challenges that do not confront the parties to transactions of far lesser magnitude or public import.

The terms of the pension "deal", including its specific provisions, must be sufficiently attractive and sellable to employers as potential plan sponsors and ultimately to employees as potential beneficiaries. It must meet demands for simplicity and restraint in its constituent rules and regulatory arrangements – including frequent challenges to the intuitiveness of specific elements viewed in isolation. It must respond to demands for fairness to similarly situated parties, including constant appeals to "level" an invisible and constantly shifting "playing field" on behalf of one interest or another. It must balance employers' and individuals' desires for choice with the risks of "adverse selection" of plans by employers and counterproductive contribution, investment, and withdrawal behavior by individuals. It also must satisfy reasonable expectations of efficiency, administrability and workability on behalf of sponsors, advisers, providers, regulators, and participants. And, in a voluntary tax-subsidized system, plans must occupy that sliver of common ground where they are sufficiently profitable to employers and other private-sector parties while delivering adequate money's worth to the taxpayers as the return on their investment.

Policy needs to keep pushing to maximize this common ground by encouraging creative methods of reducing cost, consolidating administrative functions, multiple-employer or

other pooling to realize economies of scale, judicious targeting of tax incentives, and other means. Where the current system cannot create sufficient overlap between the interests of employers and the taxpayers, it may be necessary to consider other approaches or institutional arrangements.

Expanding the common ground is hard, but encouraging creative efforts to do so will help ensure that our employer plan system --defined benefit plans as well as defined contribution plans and hybrids -- continues to play a central role.

Mr. Chairman, I would be pleased to answer any questions you and the Members of the Subcommittee might have.

J. Mark Iwry

J. Mark Iwry served from 1995 to 2001 as the Benefits Tax Counsel at the U.S. Department of the Treasury. During that time, he was the principal Executive Branch official directly responsible for tax policy and regulation relating to the Nation's tax-qualified pension and 401(k) plans and other employee benefits. He is currently a nonresident Senior Fellow at the Brookings Institution.

Mr. Iwry was previously a partner in the law firm of Covington & Burling, specializing in pensions, executive compensation, health care and other employee benefits.

Mr. Iwry has testified before various congressional committees, chaired the D.C. Bar Employee Benefits Committee, co-authored a volume on 401(k) plans, and spoken before more than 200 professional, industry and other groups. While in government, he was widely recognized for his work with the business, financial, professional and nonprofit communities to expand coverage while simplifying and rationalizing pension and benefits law. In 2001 he received the Secretary of the Treasury's Exceptional Service Award "[i]n recognition of his outstanding leadership and accomplishments ....Widely respected as Treasury's benefits and pension expert, Mr. Iwry excelled at building coalitions of diverse interests... His technical acumen and leadership have garnered praise from colleagues within Treasury, IRS, the Congress, and the employee benefits community at large."

Mr. Iwry played a central role in developing the Saver's Credit to expand 401(k) and IRA coverage of moderate- and lower-income workers (claimed last year on over 3 ½ million tax returns) and the "SIMPLE" 401(k)-type plan for small businesses (currently covering an estimated 1½ to 2 million workers). He also has initiated or orchestrated numerous other significant improvements and simplifications of the Nation's pension system and benefits law and regulation, such as approval and expansion of automatic enrollment in 401(k) and 403(b) plans, the automatic rollover IRA to curtail pension leakage, repeal of the complex section 415(e) combined limit on pensions, simplification and liberalization of the IRA and qualified plan minimum required distribution rules, simplification of highly compensated employee determinations, incentives for immediate 401(k) participation, and development of workable rules for pension portability and for health care portability, anticutback relief, 401(k) safe harbor plans, same desk rule and other benefits in corporate transactions, electronic plan administration, new comparability, COBRA, Social Security taxation of deferred compensation, and cafeteria/flexible benefit plans.

Mr. Iwry received a special award from the IRS (Office of Chief Counsel) in 2001 "[i]n recognition of the collegial working relationship you have fostered between [Treasury] and the IRS Office of Chief Counsel and of your many contributions to our nation's tax system." He has regularly advised Members of Congress and congressional staff on both sides of the aisle, and his views are frequently solicited by and reported in the New York Times, Wall Street Journal, Washington Post and other major media and trade press.

The Benefits Tax Counsel is the principal Treasury Department official directly responsible for tax policy, legislative and regulatory, relating to pensions, retirement savings, employer-provided health care, and other employee benefits, including executive compensation, golden parachutes, cash balance plans, ESOPs, stock options, IRAs, long-term care, and MSAs, and is the principal legal adviser to the Secretary of the Treasury in these areas. The BTC's responsibilities also include worker classification and issues relating to Social Security individual account proposals. The BTC represents Treasury and the Executive Branch in testimony before Congress, in working with industry, labor, and the nonprofit sector, and through public speaking.

Mr. Iwry is an honors graduate of Harvard College and Harvard Law School, and holds a Master of Public Policy degree from Harvard's Kennedy School of Government.

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Committee on Education and the Workforce

Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)

Your Name: J. Mark Iwry		
1. Will you be representing a federal, State, or local government entity? (If the answer is yes please contact the Committee).	Yes	No X
2. Please list any federal grants or contracts (including subgrants or subcontracts) which you have received since October 1, 1998: None		
3. Will you be representing an entity other than a government entity? None	Yes	No X
5. Please list any offices or elected positions held and/or briefly describe your representational capacity with each of the entities you listed in response to question 4: N/A		
6. Please list any federal grants or contracts (including subgrants or subcontracts) received by the entities you listed in response to question 4 since October 1, 1998, including the source and amount of each grant or contract: N/A		
7. Are there parent organizations, subsidiaries, or partnerships to the entities you disclosed in response to question number 4 that you will not be representing? If so, please list: N/A	Yes	No

Signature: [signature] Date: 6/2/03

Please attach this sheet to your written testimony.

APPENDIX F – SUBMITTED FOR THE RECORD, STATEMENT OF J. MARK IWRY, "EXPANDING THE SAVER'S CREDIT"

Testimony of J. Mark Iwry[1]

Before the Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
United States House of Representatives

Expanding the Saver's Credit

Chairman Johnson, Ranking Member Andrews and members of the Subcommittee, I am submitting this written statement in response to the Subcommittee's request for additional views following its June 4, 2003 hearing on defined benefit pension plans. Among other issues,[2] I have been asked to submit my views as to how Congress might expand pension coverage by making better use of the saver's credit under section 25B of the Internal Revenue Code.[3] That is the subject of this statement.

I. The Saver's Credit

In 2001, Congress established a nonrefundable income tax credit for voluntary retirement savings contributions to 401(k) and other employer-sponsored retirement plans, and to IRAs (the "saver's credit").[4] The saver's credit provides what is in effect a government matching contribution for individuals' contributions to 401(k)s, SIMPLE plans, IRAs and other plans -- in the form of a tax credit of up to 50% of an individual's contributions up to $2,000 per year. It applies to individuals whose adjusted gross income (AGI) does not exceed $50,000 a year (for those filing their federal income tax return jointly; $25,000 for single filers).

The saver's credit is one of the most significant targeted initiatives ever enacted to promote tax-qualified retirement savings for moderate- and lower-income workers. This is important not only as a matter of relative need and equity. It is

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[1] The witness served as the Benefits Tax Counsel of the U.S. Department of the Treasury from 1995 through 2001. In that capacity, he played a central role in developing the saver's credit, together with his staff in the Office of Benefits Tax Counsel and with Len Burman and his staff in the Office of Tax Analysis, within the Treasury Department's Office of Tax Policy. The witness currently is a lawyer and a nonresident Senior Fellow at the Brookings Institution. The views expressed in this testimony are those of the witness alone. They should not be attributed to the staff, officers, or trustees of the Brookings Institution or to any other organization.

[2] At or after the Subcommittee's June 4, 2003 hearing on defined benefit pension plans, where I testified on a panel that included Messrs. Gebhardtsbauer, Leary and VanDerhei, the witnesses were asked on behalf of members of the Subcommittee to submit additional statements regarding several specific issues. The requests directed to me included a request for information regarding possible approaches for addressing the cash balance pension issue. I have submitted a separate written statement to the Subcommittee on that issue. In addition, in response to requests on behalf of the Subcommittee for data on the incidence and uses of lump sum distributions from retirement plans and for views regarding a possible approach that would provide relief from certain regulation of defined contribution plans to employers that also sponsor certain defined benefit plans, I have submitted a separate written statement on behalf of myself and Mr. VanDerhei.

[3] This request for a written expansion of my remarks for the record was made by Congressman Andrews.

[4] Section 618 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Public Law 107-16, 115 Stat. 38, enacted the saver's credit into law by adding section 25B to the Internal Revenue Code (IRC). See also IRS Announcement 2001-106, 2001-44 I.R.B. (Oct. 29, 2001); IRS News Release IR 2001-107, 2001-44 I.R.B. 416 (Oct. 29, 2001).

also important as a matter of efficiency in promoting national saving. Tax expenditures that are of use mainly to the affluent tend to be inefficient to the extent that they induce higher-income people simply to shift their other savings to tax-favored accounts. But contributions and saving incentives targeted to moderate- and lower-income workers tend to increase net long-term saving, thereby enhancing retirement security for those who need it most and advancing the goals of our tax-favored pension system in a responsible, cost-effective manner.

The saver's credit was long in the making. It emerged as the end product of much larger-scale efforts to expand pension coverage during the late 1990s and 2000. The proposal was developed chiefly within the Treasury Department, with substantial involvement of private-sector stakeholders, including representatives of plan sponsors, the financial services industry (as providers to plans and IRA trustees and custodians), participants, pension professionals, and others. Its design was substantially influenced by comments from these stakeholders, and the proposal was revised in the House and Senate, before it was enacted on a bipartisan basis in EGTRRA (under the leadership of Senator Max Baucus, Ranking Member, and Senator Bill Roth, then Chairman, of the Senate Finance Committee, as well as Congressman Earl Pomeroy in the House).

The credit was designed to address the fact that more than 75 million workers and their spouses have no employer plan coverage, to help correct the top-heavy distribution of benefits in our current pension system, and to counteract what might be the central defect of our pension tax incentive structure: that the incentives – whether exclusions from income of contributions and earnings or tax deductions – are based mainly on the individual's marginal income tax rate or tax bracket. Therefore, those who most need the additional retirement security – those in the lower tax brackets, especially workers who are in the zero income tax bracket but who pay payroll taxes – have the least to gain from contributing or from demanding employer pensions. Accordingly, participation in tax-qualified plans is far lower among moderate- and lower-income individuals.

A tax credit, especially if refundable, as the savers credit was originally designed to be, puts individuals in different tax brackets on a more equal footing. The saver's tax credit is provided in addition to any other tax benefits generated by the retirement contributions (such as a tax deduction for a contribution to a traditional IRA).

The saver's credit was also carefully designed to support and enhance the employer plan system, instead of competing with it. By in effect matching lower-income workers' contributions to 401(k) and other plans – in addition to any matching contributions the employer might make under the plan – the saver's credit encourages contributions by workers who might not otherwise save. This makes it easier for plans to pass the 401(k) nondiscrimination tests, which in turn

increases the amount of tax-favored 401(k) contributions highly paid employees can make.

An IRS news release issued shortly before the saver's credit took effect stated,

> "Qualifying employees should make plans now to benefit from the new Saver's Credit next year, the Internal Revenue Service advises. This tax credit ...will help offset the cost of the first $2,000 contributed to IRAs, 401(k)s and certain other retirement plans.
>
> "The credit encourages saving for retirement," said IRS Commissioner Charles O. Rossotti. "We want workers to know about the Saver's Credit so they can take full advantage of it."[5]

The saver's credit also may induce more small businesses to adopt 401(k) and SIMPLE plans. As noted, it increases employees' financial incentive to demand the opportunity to contribute to such plans. In addition, some small businesses would consider adopting a 401(k) plan if they had the wherewithal to make matching contributions in order to induce enough participation by nonhighly paid employees to meet the 401(k) nondiscrimination standards. The saver's credit steps in to provide some of that incentive for nonhighly paid employees to participate in a 401(k) or other contributory plan.

It is worth noting that the saver's credit incentive applies to encourage voluntary employee contributions to defined benefit plans as well as defined contribution plans (such as contributions (pretax or after-tax) to 401(k)s, 403(b)s, 457 plans, and SIMPLE plans) and IRAs.

II. Experience to Date

The first tax year for which the saver's credit was available was 2002. Based on initial IRS data, I have estimated that roughly 3 1/2 million tax returns claimed the saver's credit for 2002.[6] The number of individuals who benefited from the credit would be larger because many of the returns were filed jointly by married couples, and in at least some cases, each spouse would have made a contribution for which a credit was claimed.

In addition, in a survey of 401(k) plan sponsors conducted in mid-2002 by Diversified Investment Advisers, 71% of plan sponsors surveyed said that the

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[5] IRS News Release IR 2001-107, 2001-44 I.R.B. 416 (Oct. 29, 2001).

[6] See, e.g., Albert B. Crenshaw, "A Saving Credit for Those Who Aren't Already Rich," Washington Post (May 11, 2003), page F4.

saver's credit had increased plan participation, and 18% said it had caused a major increase in participation.[7]

Before it was enacted, the revenue cost of the saver's credit was estimated by the Joint Committee on Taxation to be about $10 billion.[8] I am not aware of reliable data on the revenue cost of the saver's credit for 2002, but my impression, based on the very rough and fragmentary data available to date, is that the actual cost is unlikely to exceed, and may well fall below, the originally estimated revenue cost for that year.

III. Need for Expansion

Eligibility for the saver's credit was drastically curtailed as the proposal went through the legislative process. First, it was made nonrefundable, cutting out as much as ¾ of the working population that was originally eligible for the 50% credit.[9] Second, the income limits were reduced to the point that a 50% credit designed for working families earning up to $60,000 or more was limited to working families earning up to $30,000, with the credit rate reduced to 20% for joint filers earning up to $32,500 and only 10% for joint filers earning between $32,500 and $50,000. Third, Congress provided for the credit to sunset after five years (2002 through 2006), even though the remainder of the EGTRRA pension provisions were enacted to remain effective for ten years.

Accordingly, I would recommend the following changes to expand the current saver's credit and make it more effective:

First, the saver's credit should be made refundable, in accordance with its original design.[10] Tens of millions of low-income workers who were intended to be helped by the savers credit are ineligible because the credit, as enacted, is nonrefundable, and these workers have no income tax liability. If direct income tax refundability proves to be politically impossible, it is worth exploring variations and alternatives. For example, a bill introduced by Senator Bingaman last year would make the saver's credit refundable, but only by matching qualifying contributions of individuals who have no income tax liability with an inflation-indexed US savings bond that is not redeemable until retirement age.[11]

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[7] See www. plansponsor.com (Plan Sponsor magazine website), July 23, 2002.
[8] Joint Committee on Taxation, JCX 51-01 (May 26, 2001) page 5. Most of this estimated revenue cost is associated with the 2002-2006 period in which the credit is effective; a modest portion of this revenue cost is attributed to the years 2007-2011, following the scheduled sunset of the credit.
[9] Peter R. Orszag and Matt Hall, The Saver's Credit, 99 Tax Notes 1541 (June 9, 2003).
[10] See, for example, H.R. 4482 (107th Cong., 2d Sess.), introduced in 2002 by then Minority Leader Gephardt, which proposed to make the saver's credit refundable.
[11] See S. 2733 (107th Cong., 2d Sess.), introduced by Senator Bingaman on July 16, 2002. In addition, if the saver's credit were to remain nonrefundable, attention would need to be given to its interaction with the child tax credit in order to ensure that the interaction does not unnecessarily reduce the incentive effect of the saver's credit .

Second, instead of a 50% credit that phases down to 20% for joint filers with AGI over $30,000, the 50% saver's credit should be expanded to cover joint filers with significantly higher incomes within the middle-income range, for example, up to $60,000, phasing out at about $70,000 or $75,000. These are workers who earn enough that they might have a greater ability and propensity to save. A similar approach was reflected in a bill introduced last year by then Minority Leader Gephardt.[12]

Third, the phasedown of the credit should be smooth, more closely resembling the phasedown of IRA eligibility by income, instead of the current saver's credit phasedown "cliffs" under which the rate drops precipitously from 50% to 20%, then to 10%, then to 0. The cliffs have the effect of creating very high marginal tax rates on additional income within certain ranges.

Fourth, instead of sunsetting after five years, the saver's credit should be made permanent or at least coextensive with the other recently enacted pension provisions.[13]

Fifth, Congress should encourage "public marketing" of the saver's credit by authorizing funds for a public service announcement campaign or other appropriate outreach and publicity, and by directing the IRS and Department of Labor to increase their efforts in this regard.

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[12] See H.R. 4482 (107th Cong., 2d Sess.). Under current law, as well as under H.R. 4482 and S. 2733, saver's credit income (AGI) eligibility levels for single filers are ½, and for head of household filers are ¾, of the AGI levels for joint filers. This statement is not proposing to change that relationship.

[13] See H.R. 1776, Pension Preservation and Savings Expansion Act of 2003, introduced by Congressmen Portman and Cardin, sections 102 (saver's credit made permanent), 401 (income limits for saver's credit eligibility expanded, but significantly less than proposed in this written statement). S. 2733 and H.R. 4482, referred to above, would also make the saver's credit permanent.

APPENDIX G – SUBMITTED FOR THE RECORD, STATEMENT OF JOHN LEARY, JULY 1, 2003

TESTIMONY OF JOHN LEARY
PARTNER, O'DONOGHUE & O'DONOGHUE
WASHINGTON, D.C.

BEFORE THE SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS
COMMITTEE ON EDUCATION AND THE WORKFORCE
UNITED STATES HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.
JULY 1, 2003

Chairman Johnson, Ranking Minority Member Andrews and Members of the Subcommittee:

Thank you for the opportunity to provide additional information supplementing my testimony before your Subcommittee on June 4, 2003 regarding "Strengthening Pension Security: Examining the Health and Future of the Defined Benefit Plan." Specifically, you asked the individuals testifying before the Subcommittee on that occasion to provide comments regarding a possible legislative proposal which would allow employers that sponsor both a defined benefit pension plan and a defined contribution pension plan to be governed by more liberal regulations in their operation of the defined contribution plan if the defined benefit plan was well funded and well administered.

As a starting point, since no legislation has been introduced, the comments I make are to be taken as general in nature, and they focus on this issue from a conceptual basis, rather than as any detailed or specific analysis. Second, my area of practice and my prior written submission and testimony to the Subcommittee pertain to multiemployer plans. Similarly, my comments on this concept have such a focus.

As I indicated in my earlier submission, multiemployer defined benefit pension plans have certain unique characteristics distinguishing them from other defined benefit plans. The multiemployer plan arises as a result of a collective bargaining agreement entered into by a local union and more than one employer. In accordance with this agreement, the bargaining parties establish a pension plan, with contributions made by the employers on behalf of all employees working for them who are covered by this agreement. Under the requirements of the Employee Retirement Income Security Act and the Taft-Hartley Act, these contributions are put into a trust, the assets of which are to be used exclusively to provide benefits to participants and to pay for the reasonable expenses of administering the plan. Administration of the plan is the responsibility of a board of trustees, to be comprised of an equal number of individuals selected by the signatory employers and the union. It is this board of trustees which is the sponsor of the multiemployer plan, an arrangement in contrast to a single employer plan, where the employer is customarily the sponsor.

It is a common practice in the multiemployer plan universe for a collective bargaining agreement to provide for employer contributions to both a multiemployer defined benefit pension plan and a multiemployer defined contribution plan. For example, an employer could enter into a bargaining agreement with a local union which would require that the employer contribute to a multiemployer defined benefit plan that is nationwide in scope and to which employers signed to bargaining agreements with many different local unions contribute. That same bargaining agreement with the local union could also direct the employer to make contributions into a multiemployer defined contribution plan established by the local union and its signatory employers and covering employees of those employers.

From the perspective of plan participants, the best circumstance in terms of providing economic security at retirement is to participate in both a defined benefit pension plan and a defined contribution plan. As I pointed out in my earlier submission, these two types of plans differ significantly in their structure and operation. A defined benefit plan provides a guaranteed benefit to the participant, and it places significant restrictions on when a participant can get a

distribution from the plan and the form in which that distribution is made. Generally, benefits are payable in a defined benefit plan only upon a participant's retirement, disability or death. Further, unless the benefit amount is very low, it will be payable as an annuity rather than as a lump sum, and married participants must receive the benefit in a joint-and survivor form payable over the lives of both husband and wife, unless both parties reject it. Additionally, investment of plan assets is directed by the board of trustees, which almost invariably retains professional money managers to handle investment matters.

All of these factors make defined benefit plans an ideal means of providing participants with significant assets throughout their life as retirees. Further, in almost all of the above ways, they can be distinguished from defined contribution plans. The latter do not guarantee a benefit amount, but instead the nature of their promise is limited to the amount to be contributed by the employer. Further, they often allow for distribution of assets prior to retirement, as by separation from covered employment, hardship withdrawals or loans. Moreover, a defined contribution plan often will permit distribution of the entire amount of the participant's account in a lump sum, provided spousal consent is given. Finally, a frequent structural element of defined contribution plans is that participants direct the investment of their account, rather than have the management of plan assets done by investment managers who are selected and overseen by the board of trustees.

I believe that all of these contrasting features show the great value of defined benefit plans as an instrument to ensure financial security at retirement, and the importance of legislation that would promote their continuation and expansion. Additionally, the above contrast shows that defined benefit plans and defined contribution plans are far from identical, and provide different types of value to their participants. Thus, it is in the interest of participants to have the opportunity to participate in both types of plans, and I would support legislation that provides encouragement to employers to offer both types of plans to their employees, such as by relaxing regulatory burdens on the defined contribution plan in certain circumstances when the defined benefit plan is well funded.

However, any legislation designed to provide incentives for employers maintaining robust defined benefit plans to offer defined contribution plans would have to be carefully tailored to take into account the unique characteristics of multiemployer plans. On the most basic level, neither any individual employer nor any group of employers is deemed the sponsor of a multiemployer plan. Rather, the sponsor of the multiemployer plan is the board of trustees comprised, as required by the Taft-Hartley Act, of an equal number of individuals from the union and the employer side. While an employer who contributes to the multiemployer plan may have the status of sponsor by virtue of being appointed as a member of the board of trustees, being an employer who contributes to the plan does not make him a sponsor. Thus, requiring an employer to sponsor a defined benefit plan to gain any relief in operation of a defined contribution plan sponsored by that same employer would not be applicable in the multiemployer context.

It would be feasible to provide the sort of relief contemplated by the subcommittee to multiemployer plans provided there existed a close symmetry between the defined benefit plan and the defined contribution plan. However, this type of relief would have to be narrowly structured. For example, it is a common practice for an employer who contributes to a

multiemployer defined benefit plan pursuant to a collective bargaining agreement to sponsor and maintain a totally separate defined contribution plan for its non-collectively bargained employees. Even if the defined benefit plan to which the employer contributed was of sufficient vitality to meet the legislative criteria, that employer should not be allowed to secure any relief in his operation of the defined contribution plan. First of all, with the defined benefit plan he is merely a contributing employer, and his role is limited solely to making the contributions required under the collective bargaining agreement. He has given no demonstration of any ability to sponsor a plan that might suggest a basis for lessening any regulatory requirements. Moreover, the universe of participants in the defined benefit plan would be completely different from that making up the defined contribution plan, with the former being collectively bargained employees and the latter non-collectively bargained. The demographic factors, as well as the design of the plans and their benefit structures, could vary greatly. In short, in this circumstance a robust defined benefit plan would give no assurance of any similar strength in the defined contribution plan. Given the central importance of protecting pension plan participants, it would seem ill-advised to provide relief to this employer in his capacity as sponsor of a defined contribution plan.

This problem is alleviated somewhat if the employer contributes to both a multiemployer defined benefit plan and a multiemployer defined contribution plan. Here the employer is not functioning as a sponsor of either plan, and also there is greater commonality in the composition of the participants in the two plans. However, even here there might be such differences between the two plans that providing regulatory relief for the defined contribution plan would be ill-advised. For example, as discussed previously, an employer could enter into a bargaining agreement with a local union requiring him to make contributions on behalf of his employees to a national multiemployer defined benefit plan to which local unions throughout the country have negotiated to have employers contribute. That same bargaining agreement could require the employer to contribute to a local multiemployer defined contribution plan established pursuant to an agreement between the local union and its employers. As a result, a robust defined benefit plan would not necessarily provide assurance that the defined contribution plan would merit deferential oversight. Since the boards of trustees of the two plans would differ, they would have different sponsors. Further, the identity of the employers would differ greatly, as would the economic conditions under which those employers would operate. Finally, the participant demographics would likely vary. For example, in the national defined benefit plan, there might be a very favorable proportion of actively working employees to retirees, whereas in the local union defined contribution plan the opposite could be the case. All of these factors suggest that any legislation be narrowly tailored to ensure that the existing participant protections of ERISA are not eroded.

In conclusion, there is merit to the concept of allowing a more lenient regulatory framework for defined contributions plans if there is a robust parallel defined benefit plan. To the extent that such legislation would increase the number of participants covered under both types of plans, it is to be supported. However, such legislation should not offer a means to increase the flight of employers from defined benefit plans to defined contribution plans, and it should not serve to weaken oversight of defined contribution plans when there does not exist a strong nexus between the defined benefit plan and the defined contribution plan.

Thank you for the opportunity to present these views to the Subcommittee, and I would be pleased to comment on any more specific proposals that are devised.

APPENDIX H – SUBMITTED FOR THE RECORD, STATEMENT OF J. MARK IWRY, "DATA REGARDING LUMP SUM DISTRIBUTIONS AND THEIR USES", AND DR. JACK VANDERHEI, "POSSIBLE RELIEF FROM DC PLAN REQUIREMENTS FOR EMPLOYERS THAT SPONSOR CERTAIN DB AND DC PLANS", JULY 1, 2003

Testimony of J. Mark Iwry[1] and Jack VanDerhei[2]

Before the Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
United States House of Representatives

July 1, 2003

Chairman Johnson, Ranking Member Andrews and members of the Subcommittee, we are submitting this joint written statement in response to the Subcommittee's request for additional information and comments for the record regarding two issues that arose during the Subcommittee's June 4, 2003 hearing on defined benefit pension plans.

The first part of this statement, prepared by Mr. VanDerhei, provides requested information regarding the incidence and uses of lump sum distributions from retirement plans. The second part of this statement, prepared by Mr. Iwry, provides requested views regarding a possible approach that would provide relief from certain regulation of defined contribution plans to employers that also sponsor "robust" defined benefit plans. Mr. Iwry concurs in the substance of the first part of this statement, and Mr. VanDerhei concurs in the substance of the second part.

I. Data Regarding Lump Sum Distributions and Their Uses

Lump sum distributions (LSDs) may be provided by either a defined benefit or a defined contribution plan. Regardless of the type of retirement plan, participants may be required to take a LSD if the value of the defined benefit accruals or defined contribution account balance does not exceed $5,000. Based on data from the 1996 Survey of Income and Program Participation (SIPP), 40.4 percent of LSD recipients, reported that they were required to take their most recent distribution while the remaining 59.6 percent took the distribution voluntarily.[3]

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[1] Mark Iwry served as the Benefits Tax Counsel of the U.S. Department of the Treasury from 1995 through 2001. He currently is a nonresident Senior Fellow at the Brookings Institution and a lawyer who has provided legal advice and assistance regarding issues referred to in this testimony. The views expressed in this testimony are those of Messrs. Iwry and VanDerhei alone. They should not be attributed to the staff, officers, or trustees of the Brookings Institution, Temple University, the Employee Benefit Research Institute, or to any other organization.

[2] Jack VanDerhei is a faculty member in the Risk, Insurance and Healthcare Management Department, Fox School of Business and Management, Temple University, and research director of the Employee Benefit Research Institute Fellows Program.

3 All data in this statement are taken from Employee Benefit Research Institute (EBRI) tabulations of recently released data from the U.S. Census Bureau -- The Pension and Retirement Plan Coverage Topical Module of the 1996 Survey of Income and Program Participation -- which includes lump-sum data for individuals through 1998. See Craig Copeland, "Retirement Plan Participation and Features, and the Standard of Living of Americans 55 or Older," August 2002 EBRI Issue Brief and Craig Copeland, "Lump-Sum Distributions: An Update," July 2002 EBRI Notes.

Excluding dollars left in the plan of a previous employer (an option which will not be available to all participants), 14.3 million persons age 21 and over reported receiving a LSD from a previous job.[4] The distribution of amounts (in nominal dollars) was skewed with a median of $5,000 and a mean of $15,402. Slightly more than 1/3 of the accounts were less than $2,500 and slightly less than 10 percent were greater than $50,000.

It is possible to identify five distinct uses for the LSDs:

1. Tax-qualified financial savings (including other employment-based retirement plans and IRAs)
2. Non-tax-qualified financial savings (e.g., savings accounts)
3. Debts, businesses and homes
4. Education expenses
5. Consumption (including purchase of consumer items and general everyday expenses)

"Leakages" from the retirement system are often defined as any amounts that either do not remain in the previous employer's plan or are rolled over into the first category above. However, it is possible in specific situations that uses in categories 2, 3 and 4 above may enhance the overall financial situation of the participant sufficiently that the eventual retirement wealth is not decreased. By contrast, most analysts would agree that expenditures in category five (consumption) are quite likely to lower participants' overall retirement wealth.

The good news based on these data is that the propensity to use these distributions for consumption has decreased over time: the proportion of LSD recipients using any portion of their most recent distribution for consumption was 20.3 percent for amounts received before 1980, 17.6 percent for the period 1980-1986, 14.4 percent for the period 1987-1993, and only 12.2 percent for the most recent period covered by the data, 1994-1998.[5]

The data also reveal a very strong impact of both age and the amount of distribution on the likelihood of using the entire portion of the most recent distribution for tax-qualified financial savings. Participants ages 21-30 at the time of the most recent distribution used the entire distribution for this purpose only 23.5 percent of the time. This number monotonically increases with age until it

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This research updates earlier studies done using the Employee Benefits Supplement to the April 1998 and 1993 Current Population Survey (CPS). For an analysis of the incidence of LSD rollovers as reported in the CPS in 1988 and 1993 see Leonard E. Burman, Norma B. Coe, and William G. Gale, "Lump- Sum Distributions from Pension Plans: Recent Evidence and Issues for Policy and Research," National Tax Journal, September 1999, pp. 553–62.

4 This includes survivors (beneficiaries of deceased participants).

5 Some of the most recent decrease may be due to the imposition of the 20 percent withholding tax imposed by The Unemployment Compensation Act of 1992.

reaches a maximum of 53.1 percent for participants age 61-64 and then decreases to 44.7 percent for those age 65 and older.

A similar relationship holds for the amount of the most recent LSD. When the amount is less than $500, only 16.7 percent of the accounts are entirely used for tax-qualified financial savings. The likelihood increases dramatically after the $5,000 threshold is reached: the percentage is 36.6 percent for amounts between $5,000 and $10,000. It continues to increase as the account balance increases and 70.7 percent of the accounts with a value of $50,000 or more are used exclusively for this purpose.

There are two additional aspects of retention of retirement savings that may be considered for defined contribution plans given the nature of the SIPP database. The first considers whether plan participants elect to retain their account balances with their former employers when given the chance (versus taking it as a LSD). As expected, the likelihood of retaining these amounts with the former employer increases with the size of the account: for accounts less than $500, only 6.1 percent choose this option; however, for accounts of $50,000 or more the percentage increases to 37.4 percent.[6]

The second aspect, and the one that may be of most relevance for defined contribution plan participants, is the percentage of participants who keep their account balances in tax-qualified savings by either rolling over their LSD to tax-qualified savings or leaving the balance with the previous employer. The following figure shows that this percentage ranges from a low of 22 percent for accounts of less than $5,000 to a high of 82 percent for accounts of $50,000 or more.

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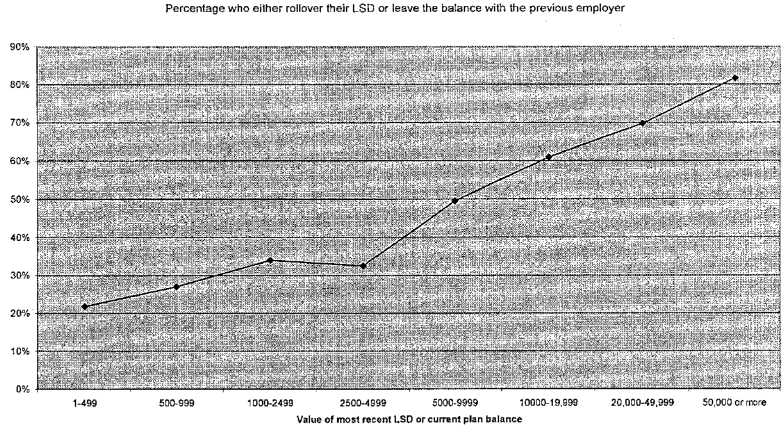
6 A study that examines this retention versus lump-sum distribution behavior using year 2000 data is Fidelity Investments, Building Futures, Volume III: A Report on Corporate Defined Contribution Plans (2001), pages 65-69. The study apparently does not reflect distributions made after 2000 yearend to terminated participants who were counted in 2000 as having retained their account balances in the former employer's plan.



Source: tabulations based on Copeland, August 2002

II. Possible Relief from DC Plan Requirements for Employers That Sponsor Certain DB and DC Plans

Chairman Johnson and Ranking Member Andrews have asked for comments regarding a possible proposal for employers that sponsor both defined benefit (DB) and defined contribution (DC) plans. This proposal has been described in Committee staff's June 16, 2003 communication to the witnesses as "... almost as a reward for having a robust DB plan, that the DC plan would be regulated in a slightly less onerous or difficult way."

As a general proposition, it can be highly advantageous to employees to be covered by both a DB and a DC plan. In combination, the particular strengths typically found in each type of plan can contribute importantly to an individual's retirement security. The advantages of DB plans (as well as DC plans) are discussed in the written testimony that was submitted for the Subcommittee's June 4, 2003 hearing.

The degree to which this is true in any given situation, however, will generally depend on the specific characteristics of the particular plans at issue. The Subcommittee's question, phrased in terms of a "robust" DB plan, seems to reflect this. The value of a DB plan will typically depend on how the particular characteristics of the plan interact with the particular characteristics of the individuals who are covered. The relevant plan characteristics include, for example

- the structure and the level (amount) of the benefit formula, including
  - traditional or hybrid formulas,
  - use of permitted disparity (traditionally referred to as Social Security integration), and
  - final average pay or career average features,
- early retirement and other retirement-related subsidies,
- death and disability benefits,
- the vesting schedule,
- distribution options,
- which employees are and are not covered and other features.

The characteristics of the employees that may be relevant often include age, length of service with the employer, and earnings, as well as their job classification (including whether their benefits are collectively bargained).

For example, the same DB plan might be "robust" for an older, longer-service individual, to whom it is of great value, while being of little or no value to a young, short-term employee. Even if both employees vest in all of their accrued benefits under the plan, under many plans the value of those benefits in the event the employee's employment terminates can be very different depending on the employee's age.

We would be happy to evaluate and comment on such a proposal; however, the only description of the proposal that has been provided is very general. In order to provide useful comments to the Subcommittee, we would need to understand the proposal more specifically, including clarification of its policy objectives. Whether the proposal would have merit, in our view, would depend in part on which aspects of the current statutory or regulatory provisions governing DC plans would be eliminated or modified, and how; whether the goals of the proposal are to encourage employers to retain existing DB plans or to adopt new ones or both (or whether the proposal has other objectives); and what would be meant by a "robust" DB plan (including the degree of overlap between the employees covered by the DB plan or plans and by the DC plan or plans).

These specifics would make possible an analysis of the merits of the proposal, including

- how it might affect important worker protections;

- the extent to which the possible reduction in requirements for DC plans would be likely to meaningfully increase employers' willingness to adopt or continue maintaining – and employees' demand for – "robust" DB plans and other qualified retirement plans;

- whether, in the aggregate, the expected reduction of benefits or protections in DC plans would be more than offset by the expected increase in benefits or protections in DB plans (taking into account the likelihood that, in response to such a provision, some employers would improve their DB plans, others might adopt new DB plans, and still others would not need to change their DB plans while reducing DC benefits or protections because their DB plans would already be "robust," including the likelihood that some employers in this last category would retain existing DB benefits that otherwise might have been frozen or reduced);

- whether it would represent a cost-efficient use of the tax expenditure;

- whether it would be equitable to employers and employees (including distributional effects);

- whether it would be administrable both for the regulators – whether the Department of Labor and IRS would be able to regulate and enforce compliance effectively – and for plan sponsors;

- its revenue cost, and

- its impact on pension and tax law complexity.

APPENDIX I – REQUEST FOR ADDITIONAL SUBMISSION FROM RON GEBHARDTSBAUER

THIS ITEM WAS NOT AVAILABLE PRIOR TO THE OFFICIAL PRINTING OF THE HEARING TRANSCRIPT. HOWEVER, UPON SUBMISSION, THE ITEM WILL BE MAINTAINED AND AVAILABLE FOR INSPECTION IN THE MAJORITY OFFICE OF THE COMMITTEE ON EDUCATION AND THE WORKFORCE

APPENDIX J – SUBMITTED FOR THE RECORD, STATEMENT OF J. MARK IWRY, "CASH BALANCE PENSION CONVERSIONS: A LEGISLATIVE FRAMEWORK FOR RESOLUTION"

Testimony of J. Mark Iwry[1]

Before the Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
United States House of Representatives

Cash Balance Pension Conversions:
A Legislative Framework for Resolution

Chairman Johnson, Ranking Member Andrews and members of the Subcommittee, I am submitting this written statement in response to the Subcommittee's request for additional information regarding cash balance conversions following the Subcommittee's June 4, 2003 hearing on defined benefit pension plans.[2]

Responding to the Subcommittee's request, this statement illustrates a possible legislative framework for resolution of the cash balance pension issue. The framework is summarized in part III (pages 3-4) and part V (pages 11-13), below.

Of course, no resolution of this highly contentious issue would leave all parties fully satisfied. There is ultimately a sharp tradeoff between protecting older workers from certain changes in plans and preserving employers' flexibility to make changes in a private pension system where they are not required to adopt or continue plans. However, the approach outlined here seeks to illustrate how Congress might find common ground – or at least middle ground – by allowing cash balance plans and conversions, resuming the IRS review and approval process, and giving plan sponsors reasonable flexibility to choose how – but not whether – to protect older workers. In a sense, plan sponsors have already pointed the way: corporate 'best practices" in a number of instances have sought to combine reasonable protection for employees with reasonable flexibility for the employer.

The material provided in this statement is illustrative, not prescriptive. It is intended to respond to the question framed by Congressman Wu, relating to how Congress could provide for cash balance conversion relief and employer

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[1] The witness served as the Benefits Tax Counsel of the U.S. Department of the Treasury from 1995 through 2001. He currently is a nonresident Senior Fellow at the Brookings Institution and a lawyer who has provided legal advice and assistance regarding issues referred to in this testimony. Any views expressed in this testimony are those of the witness alone. They should not be attributed to the staff, officers, or trustees of the Brookings Institution or to any other organization.

[2] At or after the June 4, 2003 hearing, where I testified on a panel that included Messrs. Gebhardtsbauer, Leary and VanDerhei, the witnesses were asked on behalf of members of the Subcommittee to submit additional statements regarding several other issues, including data on the incidence and uses of lump sum distributions from retirement plans and views regarding a possible approach that would provide relief from certain regulation of defined contribution plans to employers that also sponsor certain defined benefit plans. In addition, I was asked to submit my views regarding possible approaches to making better use of the saver's credit under section 25B of the Internal Revenue Code to expand pension coverage. Written statements addressing those three issues are being submitted separately to the Subcommittee.

flexibility, but not to make recommendations or offer opinions of the witness (or any other party).

I. Preliminary Matters

The cash balance pension issue has been the subject of sharply differing views, reflected in proposed legislation, legislative and policy debate, litigation, comments on regulations, academic writing, editorials, etc. In addition, the issues relating to cash balance plans and conversions of traditional defined benefit (DB) pension plans to cash balance plans and other hybrid pension programs are relatively involved.[3]

In the interest of brevity, therefore, and recognizing that the information request is in the nature of a followup to the June 4, 2003 hearing (most of which did not focus specifically on cash balance issues), this statement is intended only to sketch out a "broad-brush" response. It does not rehearse the legal or policy issues presented by cash balance plans and conversions; it does not go into detail regarding the specifics of the approaches outlined here; it certainly does not purport to illustrate how all of the important related issues and major questions in this area might be resolved; and, as noted, it is illustrative or descriptive rather than prescriptive. In the event that the Subcommittee wishes to have further information, I would be glad to respond.

II. Cash Balance Conversion Relief and Employer Flexibility

For purposes of this submission, I understand the request for information regarding conversion relief and employer flexibility to be asking essentially the following question: If Congress wished to allow cash balance pension plans to be maintained and cash balance conversions to take place, how might it do so while providing reasonable protection for employees and reasonable flexibility for employers?

A central policy concern raised by cash balance plans is whether and how conversions from traditional defined benefit to cash balance plans can be carried

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[3] Hybrid plans, such as cash balance pension plans are plans of one type – defined benefit (DB) or defined contribution (DC) – that also have characteristics of the other type. In some respects, cash balance plans resemble DC plans. They are presented to employees using DC plan concepts, with an account that increases over time as a result of interest and compensation credit. In addition, the pattern of economic accrual under a cash balance plan (i.e., each employee is credited with a hypothetical allocation which is a percentage of that employee's compensation for that year) is closer to the economic accrual under a traditional DC plan than under a traditional DB plan design. However, a cash balance plan is not a DC plan because an individual's benefits under a cash balance plan are not solely derived from the individual's allocated contributions plus attributable investment return. Therefore, cash balance plans are DB plans.

The material in this footnote is quoted essentially verbatim from prior testimony of the witness (while serving in the Treasury Department):Testimony of J. Mark Iwry, Benefits Tax Counsel, Office of Tax Policy, U. S. Department of the Treasury, before the Committee on Health, Education, Labor and Pensions, United States Senate, page 4. That testimony contains further discussion of cash balance plans and conversions.

out in a manner that sufficiently protects older and long-tenured employees who would otherwise be adversely affected -- without unduly limiting employer flexibility to change their plans and without stifling innovation and creativity in the market and in pension design.[4] In fact, among the significant legal issues that have been raised regarding cash balance plans are whether the plans are inherently age discriminatory and whether conversions are age discriminatory -- particularly whether the plans or conversions violate the age-related proscriptions of section 411(b)(1)(H) of the Internal Revenue Code (IRC) and its counterpart provisions under the Employee Retirement Income Security Act of 1974 (ERISA) and the Age Discrimination in Employment Act (ADEA).

Plan sponsors undertaking cash balance conversions have adopted a range of provisions intended to provide varying degrees of transition protection to current employees.[5] Some of these protective provisions might be described as corporate "best practices" that are generally similar to the "choice" requirements that would be imposed by H. R. 1677, the Pension Benefits Protection Act, introduced by Congressman Bernie Sanders and this Committee's Ranking Member, Congressman George Miller, and co-sponsored by other Members. The bill requires companies that convert to cash balance plans to allow workers who are either at least 40 years old or have at least 10 years of service the choice to remain in the traditional defined benefit plan.

Other converting employers have provided protection that would not meet the standard established in H.R. 1677, but would substantially exceed the requirements that would be imposed by the December 2002 proposed Treasury regulations.[6] Of course Congress should not view the proposed regulations as a source of potential guidance concerning the appropriate policy balance here. Treasury is operating under a major constraint:: it is required to interpret the current statute. While there is controversy as to whether the proposed regulations represent an appropriate interpretation, Treasury is not entirely free to publish regulations reflecting what it believes to be the best policy because of course the regulations generally must give effect to or interpret existing statutory provisions.

III. Possible Framework for a Legislative Solution

As noted, a possible legislative resolution of the cash balance issue could allow cash balance plans and conversions, resume the IRS review and approval process, and give plan sponsors reasonable flexibility to choose how – but not whether – to protect older workers.

By way of illustration, legislation could include the following ten elements:

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[4] The material in this paragraph is drawn largely from the witness's June 4, 2003 testimony, written statement, pages 5-6, 18-19.
[5] U. S. General Accounting Office, Cash Balance Plans: Implications for Retirement Income, pages 34-36 (2000).
[6] See id.

1. Provide that cash balance plans will not be treated as inherently age discriminatory, i.e., that new or steady-state cash balance plans do not per se violate the age discrimination laws if they would satisfy the defined contribution plan age discrimination standard of IRC section 411(b)(2).
2. As a condition of treating a conversion as not violating the statutory age discrimination provisions, require the plan to give older workers a reasonable level of protection from the adverse effects of the conversion, including protection from normal and early retirement benefit wearaway.
3. Prescribe the minimum level of protection in a manner that maximizes employers' flexibility to choose among a specified array of "safe harbor" alternatives for designing their protective arrangements (discussed below).
4. Give employers further flexibility by providing a "safety valve", allowing individual plan sponsors to demonstrate to the IRS that their conversion provisions are substantially as protective of older participants as at least one of the safe harbors. This could include a "facts and circumstances" demonstration.
5. Give IRS specified additional FTE and budgetary resources to help it address the cash balance backlog, provided Treasury/IRS concur. A conversion that is the subject of such a safety valve application (see #4, above) could not be implemented before IRS had received such additional FTEs and funds or without an IRS determination letter. IRS would be authorized to prescribe reasonable conditions to limit the volume of such case-by-case applications.
6. Direct Treasury to propose, after consultation with EEOC and DOL, regulations implementing the safe harbors and related legislation (replacing the December 2002 proposed regulations, at least to the extent they are inconsistent with the new legislation) and, after issuance of final regulations, to resume the IRS determination letter review process for cash balance conversions.
7. Possibly authorize Treasury to publish additional safe harbors that are not less protective of older or longer-service participants than the statutorily described safe harbors and that would not go into effect until after a longer than usual period following their submission to Congress in proposed form.
8. Direct Treasury to fine tune the safe harbors to the extent necessary to coordinate conversion protections for older workers with other plan qualification rules, including the prohibitions on discrimination in favor of highly compensated employees and restrictions on "backloading" of benefits.
9. Provide that the legislation is intended to have no effect on existing or possible future litigation relating to conversions that have received IRS determination letters (including a congressional decision as to the regime to apply to the past conversions that IRS has not processed) and is intended to have no effect on the application or interpretation of the age discrimination laws beyond the limited sphere of hybrid pension plans and conversions.
10. To the extent practical, take steps to clarify the application of related plan qualification provisions to hybrid plans.

IV. Building Blocks for Constructing Conversion Safe Harbors

A. In General

In considering how to design options that employers can use to protect current employees affected by a conversion, it is important to bear in mind that employer flexibility to choose among a menu of alternatives means that, in many instances, the protection will be only as strong as the weakest alternative. In accordance with the Subcommittee's request for information and hence the character of this submission as descriptive rather than prescriptive, this comment is not intended to advocate or recommend a particular approach regarding the degree or specific nature of the conversion protection Congress should require. Determining how much protection to require for current employees from the potential adverse effects of a conversion depends on how the nature and gravity of those effects are viewed and on how employees' interests in protecting their benefits are balanced against plan sponsors' need for flexibility and the potential impact on their willingness to maintain plans.[7]

B. Full Protection of Benefit Expectations

According to one view, the law should protect older workers' expectations of future higher benefits under a traditional DB plan from the effects of a conversion – as some employers have done – because older workers have given up current wages (whether implicitly or explicitly) in exchange for a traditional pension formula that provides only modest benefits in the employee's earlier years on the understanding that longer-serving employees will be more richly rewarded late in their career. In addition, under a related view, conversions often discriminate against older workers, treating them less favorably than younger employees. These concerns might suggest requiring older or longer-service employees to be grandfathered in the old formula benefit, giving them the greater of the old and new formula benefit, or giving them a choice between the two formulas at retirement.[8] See, for example, H.R. 1677.

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[7] The discussion in this part does not address concerns that have been raised to the effect that the basic structure of the cash balance plan formula generally fails to comply with the existing provisions of IRC section 411(b)(1)(H) and similar ADEA and ERISA prohibitions on reduction in the rate of benefit accrual because of the attainment of any age. To the extent that concerns such as these are viewed as more in the nature of legal concerns under the current statutory provisions than policy concerns, they could be addressed as part of a legislative package, such as that outlined here, that would protect older workers from the adverse effects of cash balance conversions. At the same time, such concerns can also reflect an underlying policy concern about the effects of cash balance plans and of legislation that might encourage them. However, given the scope of the Subcommittee's request for information, this submission does not attempt to address the debate regarding the policy merits and drawbacks of hybrid plans.

[8] Some contend that employee choice regarding such technical matters is less appropriate than grandfathering employees in the old formula to the extent it would provide a greater benefit at retirement. Under this view, permitting employees a choice at retirement amounts to little more than offering a choice between more money and less – an exercise that is either wasted motion or, in a few cases, unnecessarily risky. And offering employees a choice at the time of conversion presents an undue risk of unwise or uninformed choices, which can ultimately result in remorse and litigation to the detriment of both

Some employers have extended such grandfathering, "greater of" treatment, or choice to a specified class of individuals who participated in the traditional DB plan at conversion (e.g., only those who have reached a certain age and/or have completed a certain period of service as of the conversion). Variations of this view – reflected in various other corporate practices -- would require such protection to last only for a limited period of years.

Under these approaches, it is assumed that where the conversion is intended to reduce pension costs for the plan sponsor or to spread the benefits of the DB plan more broadly among the work force, the temporary transition relief for current employees will not prevent the sponsor from realizing those benefits in the long run, as the number of nongrandfathered employees grows while the number of grandfathered employees diminishes.

C. Preventing the Worst of Both Worlds

A different view is driven more by a recognition of the employer's ability to freeze or terminate a DB plan, even a traditional one with a "backloaded" pattern of benefits, and by a concern about the impact on the private employer-sponsored pension system of beginning to require qualified plan sponsors to protect employee expectations of future benefit accruals. For some, however, this view is tempered by a concern about what is sometimes called the "bow tie effect": the fact that a conversion can result in a smaller total benefit for an employee than if he or she had been covered by the cash balance plan for the employee's entire career, because, during the early years of one's career, the traditional DB might provide smaller benefits than the cash balance plan.

Thus, some would hold that even if it were impractical for the system to require converting employers to guarantee their workers the best of both worlds (the greater of the old and new formulas or a choice between them), it should at least require employers to protect their employees from the worst of both worlds. One method of preventing the "bow tie" effect is to establish an opening account balance equal to the present value of a hypothetically "reconstructed" cash balance benefit. This would be the benefit the employee would have earned before the conversion date had the cash balance formula covered the employee since he or she began work with the employer (assuming that amount exceeds the present value of the employee's actual pre-conversion accrued benefit under the traditional DB plan). Alternatively, if the "sum-of" (A+B) method is being used, and if the present value of the A piece (the frozen old-formula benefit) is less than the hypothetically reconstructed preconversion cash balance benefit,

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employees and employers. In view of the risk of eventual litigation, the concern has been expressed that choice at conversion puts excessive pressure on the accuracy, comprehensiveness, and usefulness of the plan sponsor's disclosures and any related assistance to employees. Choice also raises issues relating to the handling of plan amendments that take effect between conversion and retirement.

then the present value of the A piece might be increased to equal that reconstructed benefit.

D. Preventing Wearaway

"Greater-of" Approach. A related adverse effect of a conversion on employees is the extended suspension of new benefit accruals that can occur after a conversion when employees are promised the greater of an old-formula benefit that is frozen (because additional service is not earning employees additional benefits under that formula) and a new-formula benefit that is less generous but that does continue to grow with additional service. This so-called "wearaway" of the frozen old-formula benefit – whereby no new net benefits are being earned so long as the frozen old-formula benefit continues to exceed the growing new-formula benefit – can apply to the normal retirement benefit (typically the benefit payable at age 65) and to the early retirement benefit. In many cases, where the early retirement benefit is "subsidized" and hence is actuarially more valuable than the normal retirement benefit, the wearaway of the early will be potentially more costly to the employee than the wearaway of the normal retirement benefit.

Some would advocate requiring protection only to the extent necessary to prevent or to simply mitigate the wearaway – of either the normal and early retirement benefits or only the normal retirement benefit. (The December 2002 proposed Treasury regulations relating to cash balance plans and conversions would require converting plan sponsors to take steps to mitigate the wearaway of the normal retirement benefit.)

"Sum-of" or "A+B" Approach. This approach would formulate protections based generally on a policy that employers should be free to stop one plan formula and start another, but without offsetting the old benefits against the new – at least not in a way that particularly disadvantages older workers. Thus, the employer could be required to mimic the result that would obtain if it froze the traditional DB plan and adopted a new cash balance plan that provided benefits wholly unrelated to the old frozen plan benefits.

This would suggest a 'sum-of" or "A+B" approach whereby employees' normal and early retirement benefits after the conversion are equal to the sum of the normal or early retirement benefits they earned before the conversion under the old plan formula and the cash balance benefits they earn after the conversion. (This "sum-of" approach is contrasted with the "greater-of" approach described above, which promises employees the greater of an old-formula frozen benefit and a growing new-formula cash balance benefit.)

Recognizing Post-Conversion Compensation Increases. A variation would require the employer to increase the "A" element – the benefit earned under the old formula before conversion – to reflect post-conversion increases in compensation (though not post-conversion service). The rationale would be that,

even if the employee is not grandfathered in the entire old formula such that it would continue to apply to service after the conversion, the final average pay feature of the old formula was a particularly key element of the employee's expectations that should be honored after the conversion. In addition, essentially indexing the pre-conversion benefit for inflation in this manner can help address the concern of those who believe that merely preventing post-conversion wearaway does too little to offset the harm to older employees.

Immediate Vesting. Another possible element would be to require full and immediate vesting of benefits (to the extent funded) upon the conversion. The rationale for this would be that the conversion, if likened to a freeze of one plan and establishment of another, has an effect similar to a partial termination of a plan that would require immediate vesting.[9]

Establishing Opening Account Balance to Prevent Wearaway of Normal Benefit. A variation on the "sum-of" approach would allow the employer, as an alternative, to establish an opening account balance under the cash balance formula that includes the full present value of the normal retirement benefit the employee had earned under the traditional plan formula before the conversion, and that grows as the employee earns cash balance pay and interest credits. Congress could require the present value to be calculated using actuarial assumptions that include the statutorily prescribed interest rate for determining present values of pension benefits. The advantage of this alternative to the "sum-of" is presentational simplicity: it presents the full normal retirement benefit, pre- and post-conversion, in a single format, as an account balance.

A major drawback, however, is that the opening account balance approach does not lend itself to preventing wearaway of early retirement benefits. (It also does not lend itself to recognizing the effect of post-conversion compensation increases on the traditional old-formula benefit.) Early retirement benefits under a traditional DB plan can be particularly valuable because they often are "subsidized" relative to the normal retirement benefit (i.e, the monthly or annual payment under the early retirement annuity is not reduced – or not reduced sufficiently -- to reflect the fact that it begins earlier and therefore is expected to make more payments than the age-65 annuity). Consequently, the opening account balance method needs to be supplemented by a contingent early retirement subsidy (the "pop-up" benefit described below).

"Pop-Up" Early Retirement Subsidy. An early retirement subsidy is a contingent benefit. Its value depends on whether and when the employee retires. An employee does not realize any early retirement subsidy if he or she terminates employment either before becoming eligible for it or after reaching normal retirement age. Consequently, the value of the subsidy is not readily captured in a post-conversion opening account balance. Attempts to do so,

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[9] Some have argued that conversions should be treated as plan terminations, triggering not only immediate vesting but also annuitization and excise and income tax on any surplus assets.

depending on how they are designed, tend to result in age discrimination, partial loss of benefits, and windfalls.

However, early retirement subsidies can be preserved on a contingent, "springing" basis. The plan keeps track of the subsidy under the old formula and prevents wearaway of the subsidy by adding it to the employee's total retirement benefit (under the old and new formulas) if and when the employee retires early and qualifies for it. This "pop-up" protection can be quite important to employees, although employers note that it comes at a cost in terms of presentational simplicity. It can also be combined with the use of an opening account balance that reflects the present value of the normal retirement benefit earned before the conversion.

E. Greater of "Sum-of" and "Greater-of".

Another variation would provide a normal retirement benefit equal to the greater of the benefit produced by the "sum-of" A+B method and the "greater-of" (opening account balance) method.

As noted,

- the "sum-of" method provides a total benefit equal to the sum of the frozen old formula pre-conversion benefit in the form expressed under the traditional plan ("A") and the new formula account balance resulting from annual post-conversion cash balance pay and interest credits ("B");

- the "greater-of" method provides a total benefit equal to the greater of the old formula frozen benefit and the new formula account balance, which in turn consists of an opening account balance equal to the present value of the pre-conversion benefit plus annual post-conversion cash balance pay and interest credits.

This prevents wearaway without the associated risk, under some circumstances, that the final benefit will be less than it would be under a "greater-of" approach.

F. "Straight-lining": Preventing Reduction of the Pre-Conversion Accrual Rate

Another view would stop short of requiring protection of employees' expectations of steadily increasing accrual rates under the traditional defined benefit plan, but would interpret the section 411(b)(1)(H) prohibition on reducing the rate of benefit accrual because of age as requiring a comparison of older and younger employees' rates of benefit accrual before and after the conversion. Instead of comparing a conversion to a freeze of one plan and fresh-start adoption of another, this approach would take the view that because the conversion is a plan amendment and the plan retains its defined benefit character, the conversion

should be analyzed as a plan amendment under IRC section 411(b)(1)(H) to determine whether it reduces the rate of benefit accrual because of age.

To permit an "apples to apples" comparison for this purpose, one could take the present value of the traditional DB plan's pre-conversion rate of accrual and express it as an equivalent allocation rate (i.e., an equivalent DC plan contribution) or cash balance pay credit.

- For example, a conversion might provide a 5%-of-pay hypothetical cash balance contribution or pay credit to all employees, including an older employee who had an accrual rate under the traditional DB plan equivalent to a 12%-of-pay contribution and a younger employee who had an accrual rate under the traditional plan equivalent to a 4%-of-pay contribution.

Under this view, the conversion would have impermissibly reduced the rate of benefit accrual on account of age. Under such an interpretation, preventing age discrimination would not require grandfathering an older employee in his or her traditional DB benefit formula, including expected future increases in the rate of benefit accrual, but only in a pay credit equivalent to the employee's pre-conversion rate of benefit accrual. Literal adoption of such an approach would give rise to a host of issues, such as the practical complexity of maintaining many different age-sensitive pay credit rates and coordination with qualified plan standards designed to prevent discrimination in favor of highly paid employees.

G. Age- or Service-Weighted Pay Credits, Interest Credits, or Opening Balances.

A practice not uncommon among converting employers has been to provide for a tiered pay credit rate under the cash balance plan – a higher pay credit percentage for older (or longer service) employees than for younger (or shorter service) employees – though not necessarily as high as would be needed to equal the older worker's pre-conversion rate of accrual (see F, above).

Congress could, if it wished, borrow a leaf from these employers. A conversion could be treated as not age discriminatory if older employees receive sufficiently high and durable cash balance pay credits – defined by reference to the pre-conversion rate of accrual, younger employees' pay credits, or an absolute percentage of pay. Like other ameliorative measures, such an approach would need to be carefully crafted to avoid doing violence to age discrimination law generally. It also would need to be coordinated with qualified plan nondiscrimination policy and standards. Higher interest credits for older employees or additional amounts credited to their opening account balances might be designated as other permissible means of offsetting the adverse effects of the conversion, if meaningful equivalencies can be determined.

V. Conversion Safe Harbors

As noted earlier, Congress could prescribe minimum standards for protecting employees from the adverse effects of cash balance conversions by giving employers flexibility to choose among a specified array of "safe harbor" alternatives for designing protective arrangements.

In addition to defining safe harbors (which could be fleshed out through regulations once they were sufficiently described in the statute), Congress would need to determine how non-safe-harbor conversions would be treated. For example, one possible approach would be to provide that a conversion that does not satisfy any safe harbor is vulnerable to challenge as age discriminatory (i.e., it reduces the rate of benefit accrual on account of age in violation of the statutory provisions) and is not entitled to an IRS determination letter covering the age discrimination issue, unless the specific facts demonstrate otherwise. Another approach would be to provide that such a conversion is subject to a rebuttable presumption that it reduces the rate of benefit accrual because of age.

As noted, this submission is not intended to advocate or recommend a particular approach regarding the amount or type of conversion protection Congress should require. In other words, it is not intended to suggest to Congress where to set the bar.

Conversion safe harbors could be constructed from the methods or "building blocks" described above. By way of illustration, possible safe harbors might include provisions along the lines of the following:

1. **Full Protection of Expected Benefits**. One safe harbor could require protection of older or longer-service employees' old-formula benefit expectations, including expectations regarding future increases in the rate of benefit accrual. This protection could take the form of being (a) grandfathered in the old formula benefit, (b) given the greater of the old and new formula benefit at retirement, or (c) given a choice between the two formulas at retirement. See IV.B, above.

- If Congress thought it appropriate, it could limit the required protection to a particular class of employees defined by age or age and service and could limit the duration of the required protection.

2. **Preservation of Pre-Conversion Rate of Accrual**. A second safe harbor might treat a conversion as not reducing the rate of benefit accrual because of age if the plan provided age-weighted (or age- and service-weighted) pay credits based on the pay credit equivalents of employees' pre-conversion rates of benefit accrual. See IV.F, above.

- If Congress thought it appropriate, it could set the bar for age-weighted pay credits somewhat lower than – but taking into account -- the level required to make employees whole relative to their pre-conversion accrual rates. The legislation could, for example, define the level of credits required for older employees by reference to the pre-conversion rate of accrual, younger employees' pay credits, or an absolute percentage of pay. Congress might also allow other types of credits – such as one-time transition credits added to the opening account balance or interest credits -- to substitute for some or all of the higher pay credits, although the determination of rough equivalencies would not be straightforward. See IV.G, above.

3. **<u>"Sum-of" (A+B) Plus Early Retirement Subsidy Pop-Up and Compensation Updates to Old-Formula Benefit</u>**. A third safe harbor might be constructed by building on the anti-wearaway protections described in IV.D, above. Just as Congress, if it decided to seek a middle ground between competing interests, would have to determine how much to limit or subtract from the basic structure of the first two safe harbors (full grandfathering), it would similarly have to decide how much to build up or add to the basic structure of this third safe harbor (the "sum-of" approach to preventing wearaway).

Often, the two aspects of the traditional DB benefit formula that contribute most to the "backloaded" character of the plan are early retirement subsidies and the final average pay feature. If it wished to, Congress could partially offset the loss of these features by, for example, designing a safe harbor that begins with the "sum-of" (A+B) method and adds both an early retirement subsidy pop-up and recognition of post-conversion compensation increases in determining the value of the "A" element (the frozen old-formula benefit). See IV.D, above.

4. **<u>Enhanced Opening Account Balance Plus Early Retirement Subsidy Pop-Up</u>**. As an alternative to the "sum-of" approach, which starts with a zero account balance after the conversion, another safe harbor could permit use of the opening account balance method outlined in IV.D, above. Under that method, the cash balance account begins by including the full present value (determined using the statutory interest rate) of the employee's pre-conversion normal retirement benefit, and grows as the employee earns cash balance pay and interest credits.

As in the previous safe harbor, early retirement subsidies under the traditional plan would be preserved via an early retirement subsidy pop-up. However, since this single account balance (opening account balance) method does not readily accommodate recognition of post-conversion compensation increases in determining benefits, the employer might be required to increase the opening account balance by a specified percentage as a rough-justice substitute.

5. **Safety Valve Facts and Circumstances Determination**. As an alternative to using a safe harbor method, employers might be given further flexibility through a "safety valve" procedure allowing individual employers to make a "facts and circumstances" demonstration to the IRS that their conversion provisions are substantially as protective of older participants as at least one of the safe harbors or that, in any event, their conversion does not reduce the rate of benefit accrual because of age in violation of IRC section 411(b)(1)(H).

Any such safety valve option would likely impose heavy demands on IRS resources. Processing such an application would be a labor-intensive procedure requiring highly trained technical personnel, who are in short supply. Accordingly, access to such a determination would need to be, in effect, rationed. This could be done by appropriately limiting the eligibility conditions. In addition, a natural rationing process might occur as plan sponsors seeking such special determinations instead of complying with one of the safe harbors would be forced to wait in the queue and probably endure substantial delays. Of course such rationing would be justifiable only if the safe harbors were reasonable.

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As an additional cross-cutting requirement, converting employers, regardless of which safe harbor they are relying on, might be required to protect employees from the "worst of both worlds" situation described in IV.C, above, using the "reconstructed account balance" described there or an alternative method.

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A number of the potential arrangements described here can be viewed as methods of giving employees "half a loaf" – although the exact fraction that is or should be provided can be expected to be the subject of vigorous debate. If Congress wishes to find middle ground on this issue and strike a balance between the legitimate competing interests, these are tools it can use (in addition to other techniques not described here). As noted, however, it is not the purpose of this submission to suggest where Congress should strike its balance along the spectrum of possible requirements from fuller protection (as in H.R. 1677) to far more limited protection (as in the provisions of the December 2002 proposed Treasury regulations that would permit an opening account balance to be established using a "reasonable" interest rate and without seeking to protect early retirement subsidies from wearaway).

In addition, this outline does not attempt to be comprehensive. It does not address many of the other issues implicated by or relevant to a legislative approach to conversions (other rules governing cash balance plans, application of a legislative approach to other hybrid plans, coordination with rules prohibiting discrimination in favor of highly compensated employees and restricting backloading, financial accounting issues, etc.).

If further information would be helpful to the Subcommittee, I would be happy to provide it.

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